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Tax & Business Alert

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THE TCJA EFFECT: QUALIFIED RESIDENCE INTEREST

The Tax Cuts and Jobs Act (TCJA) made a significant impact — both directly and indirectly — on the deductibility of various types of interest expense for individuals. One area affected is qualified residence interest.

TWO WAYS ABOUT IT

The TCJA affects interest on residential loans in two ways. First, by nearly doubling the standard deduction and placing a $10,000 cap on deductions of state and local taxes, the act substantially reduces the number of taxpayers who itemize. This means that fewer taxpayers will benefit from mortgage and home equity interest deductions. Second, from 2018 through 2025, the act places new limits on the amount of qualified residence interest you can deduct.

Previously, taxpayers could deduct interest on up to $1 million in acquisition indebtedness ($500,000 for married taxpayers filing separately) and up to $100,000 in home equity indebtedness ($50,000 for married taxpayers filing separately).

Acquisition indebtedness is debt that's incurred to acquire, build or substantially improve a qualified residence, and is secured by that residence. Home equity indebtedness is debt that's incurred for any other purpose (such as buying a boat or paying off credit cards) and is secured by a qualified residence. A single mortgage could be treated as both acquisition and home equity indebtedness, allowing taxpayers to deduct interest on debt up to $1.1 million.

The TCJA reduced the deduction limit for acquisition indebtedness to interest on up to $750,000 in debt and eliminated the deduction for home equity indebtedness altogether, through 2025. The new limit on acquisition indebtedness doesn't apply to debt incurred on or before December 15, 2017, subject to an exception for mortgages that were incurred on or before April 1, 2018, in certain circumstances. Specifically, it involves debt incurred pursuant to a written binding contract to purchase a qualified residence executed before December 15, 2017, and scheduled to close before January 1, 2018 (so long as the purchase, as it turned out, was completed before April 1, 2018). And it doesn't apply to existing mortgages that are refinanced after

INVESTMENT INTEREST ALSO AFFECTED

The Tax Cuts and Jobs Act (TCJA) also affects investment interest. This is interest on debt borrowed to buy taxable investments (margin loans, for example). Like qualified residence interest, investment interest is an itemized deduction, which is lost if you no longer itemize.

Deductions of investment interest cannot exceed your net investment income, which generally includes interest income and ordinary dividend income, but not lower-taxed capital gains, qualified dividends or tax-free investment earnings. For many people, net investment income is now higher because the TCJA eliminated miscellaneous itemized deductions for such expenses.

December 15, 2017, provided the resulting debt doesn't exceed the refinanced debt.

The elimination of interest deductions for home equity indebtedness, however, applies to existing debt. So, if you were previously deducting interest on up to $100,000 of home equity debt, that interest is no longer deductible. The same holds true for the $100,000 home equity portion of $1.1 million in mortgage debt. Note, however, that interest on a home equity loan used to substantially improve a qualified residence is deductible as acquisition indebtedness (subject to applicable limits).

REVIEW YOUR EXPENSES

In light of the TCJA's changes, you may want to make changes such as paying off home equity loans because interest is no longer deductible. Contact us for help. ■

CAREFUL TAX PLANNING REQUIRED FOR INCENTIVE STOCK OPTIONS

Incentive stock options (ISOs) are a popular form of compensation for executives and other key employees. They allow you to buy company stock in the future at a fixed price equal to or greater than the stock's fair market value on the ISO grant date. If the stock appreciates, you can buy shares at a price below what they're then trading for. But careful tax planning is required because of the complex rules that apply.

TAX ADVANTAGES ABOUND

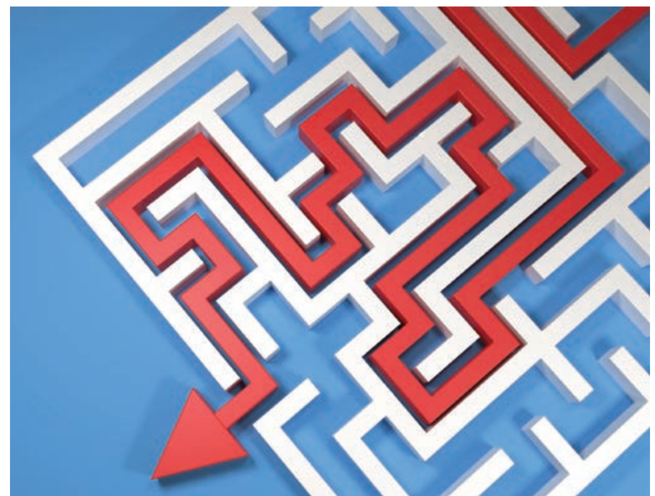
Although ISOs must comply with many rules, they receive tax-favored treatment. You owe no tax when ISOs are granted. You also owe no regular income tax when you exercise ISOs. There could be alternative minimum tax (AMT) consequences, but the AMT is less of a risk now because of the high AMT exemption under the Tax Cuts and Jobs Act.

There are regular income tax consequences when you sell the stock. If you sell after holding it at least one year from the exercise date and two years from the grant date, you pay tax on the sale at your long-term capital gains rate. You also may owe the 3.8% net investment income tax (NIIT).

If you sell the stock before long-term capital gains treatment applies, a "disqualifying disposition" occurs and a portion of the gain is taxed as compensation at ordinary-income rates.

2019 IMPACT

If you were granted ISOs in 2019, there likely isn't any impact on your 2019 income tax return. But if in 2019 you *exercised* ISOs or you sold stock you'd acquired via exercising ISOs, then it could affect your 2019 tax liability. It's important to properly report the exercise or sale on your 2019 return to avoid potential interest and penalties for underpayment of tax.



PLANNING AHEAD

If you receive ISOs in 2020 or already hold ISOs that you haven't yet exercised, plan carefully when to exercise them. Waiting to exercise ISOs until just before the expiration date (when the stock value may be the highest, assuming the stock is appreciating) may make sense. But exercising ISOs earlier can be advantageous in some situations.

Once you've exercised ISOs, the question is whether to immediately sell the shares received or to hold on to them long enough to garner long-term capital gains treatment. The latter strategy often is beneficial from a tax perspective, but there's also market risk to consider. For example, it may be better to sell the stock in a disqualifying disposition and pay the higher ordinary-income rate if it would avoid AMT on potentially disappearing appreciation.

The timing of the sale of stock acquired via an exercise could also positively or negatively affect your liability for higher ordinary-income tax rates, the top long-term capital gains rate and the NIIT.

NICE PERK

ISOs are a nice perk to have, but they come with complex rules. For help with both tax planning and filing, please contact us. ■

OWN A PASS-THROUGH ENTITY? BEWARE THE IDES OF MARCH

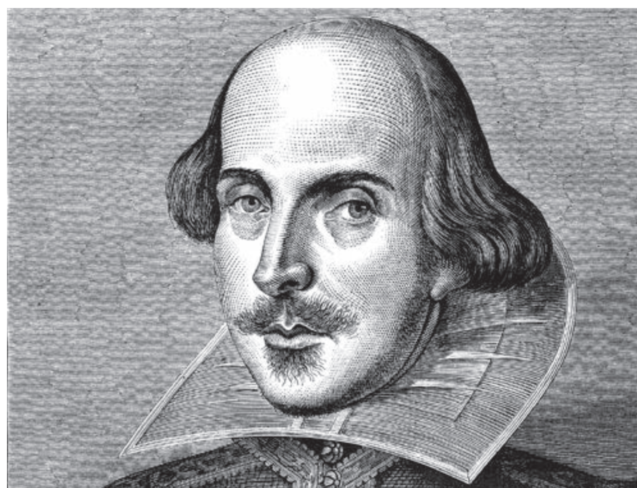
"Beware the Ides of March." Shakespeare's words don't apply just to Julius Caesar; they also apply to calendar-year partnerships, S corporations and limited liability companies (LLCs) treated as partnerships or S corporations for tax purposes. Why? The Ides of March — March 15 — is the federal income tax filing deadline for these "pass-through" entities.

NOT-SO-ANCIENT HISTORY

Until the 2016 tax year, the filing deadline for partnerships was the same as that for individual taxpayers: April 15 (or shortly thereafter if April 15 fell on a weekend or holiday). But the due date was changed to allow business owners to use the information contained in the pass-through entity forms to file their personal returns. For partnerships with fiscal year ends, tax returns are now due the 15th day of the third month after the close of the tax year. The same deadline applies to fiscal-year S corporations.

AVOIDING A TRAGEDY

If you haven't yet filed your calendar-year partnership or S corporation return, you can avoid the tragedy of a late return by filing for an extension. Under the current law, the maximum extension for calendar-year partnerships is six months (until September 15, 2020, for 2019 returns). This is up from five months under the old law. So, the extension deadline is the same — only the length of the extension has changed. The extension deadline for calendar-year S corporations also is September 15, 2020, for 2019 returns. Whether you'll be filing a partnership or an S corporation return, you must file for the extension by March 15 if it's a calendar-year entity.



EXTENDING THE DRAMA

Filing for an extension can be tax-smart if you're missing critical documents or you face unexpected life events that prevent you from devoting enough time to your return right now.

But to avoid potential interest and penalties, you still must (with a few exceptions) pay any tax due by the unextended deadline. There probably won't be any tax liability from the partnership or S corporation return. But, if filing for an extension for the entity return causes you to also have to file an extension for your personal return, it could cause you to owe interest and penalties in relation to your personal return.

TO FILE OR TO EXTEND

We can help you file your tax returns on a timely basis or determine whether filing for an extension is appropriate. Contact us today. ■

ACCOUNTING FOR THE NEAR AND THE LONG TERM IN A FAMILY BUDGET

A wise person once said, "Simplicity is the key to a family budget." (He or she may or may not have been an accountant.) However, it also needs to be comprehensive enough to cover all necessary items. To find the right balance, a budget should cover two distinct facets of family members' lives: the near term and the long term.

In the near term, the budget should encompass the day-to-day items that affect every family. First, the home: This is often the most valuable possession in a personal budget. And a budget shouldn't include only mortgage payments, but also expenses such as utilities, maintenance and supplies.

Naturally, there are other items related to daily life that need to be accounted for. These include groceries, fuel, clothing, child care, insurance and out-of-pocket medical expenses. And families need to draw clear distinctions between fixed and discretionary spending.

Along with being a practical guide to near-term family spending, the budget needs to address long-term goals. Of course, some goals are further out than others. For example, virtually everyone's longest-term objective should be to have a comfortable retirement. So, a budget needs to incorporate plan contributions and other ways to meet this goal.

A relatively less long-term goal might be funding one or more college educations. So, again, the budget should reflect efforts to this effect. And, as a long-term but "as soon as possible" objective, the budget needs to be structured to pay off debts and maintain a strong credit rating. Our firm can help you craft a sensible budget that addresses your family's distinctive needs. ■

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