

# New Tax Law Eliminates Personal Exemptions And Increases Standard Deduction

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This is the second alert in a weekly series highlighting the major changes to the law as a result of the Tax Cuts and Jobs Act of 2017 (the “Act”). The Act introduced the most sweeping changes to the tax law in the last 30 years, impacting every individual, business, trust and estate. This week, we will focus on the elimination of the personal and dependency exemptions, as well as the increase in the standard deduction. These changes are effective for the 2018 tax year; however, they are automatically repealed at the end of 2025, without further legislative action. Starting in 2026, the deduction for personal and dependency exemptions are scheduled to be reinstated and the increased standard deduction will no longer apply.

## **Repeal of Deduction for Personal and Dependency Exemptions**

Prior to 2018, when determining taxable income, an individual could reduce his or her adjusted gross income by a specified amount referred to as the personal exemption deduction. In 2017, an individual taxpayer could claim a personal exemption for themselves, his or her spouse, and any qualified dependents. In 2017, the personal exemption deduction was \$4,050 per person. However, the exemption was subject to a gradual phase-out at certain income thresholds, depending upon the taxpayer’s filing status.

In addition to personal exemptions, in 2017 the law permitted a taxpayer to take a dependency exemption for each individual who (1) was related to the taxpayer in a specified manner (ordinarily by blood, marriage, or adoption); (2) received more than one half of his or her support from the taxpayer or satisfied a special support requirement; and (3) did not have gross income exceeding the exemption amount or was a child of the taxpayer who was either below the age of 19 or a student under the age of 24. This was commonly referred to as the “dependency exemption.” The Act eliminated the personal exemption for the tax filer, his or her spouse and also eliminated the dependency exemption

for dependent children and related individuals.

## **Increased Standard Deduction**

U.S. Tax Policy has always included the concept of reducing taxable income by certain expenditures that Congress believed were important for one reason or another. These included the deduction for taxes paid to states and local governments, interest on certain home mortgages, charitable contributions and the like. The standard deduction, when it was introduced into the tax code, was justified as a means of simplifying the preparation of returns by eliminating the burden of itemizing deductions for most taxpayers. In 2017, the standard deduction consisted of a basic standard deduction, which varied depending on the taxpayer's filing status, plus, where applicable, an additional standard deduction for the elderly (65 or over) or the blind. Both were adjusted for inflation. In 2017, the basic standard deduction was \$12,700 for joint filers, \$9,350 for head of household filers, and \$6,350 for single filers and married taxpayers filing separately. A taxpayer elected the standard deduction by filing a return and claiming no itemized deductions.

Under the Act, starting in 2018, the basic standard deduction has increased to \$24,000 for joint filers, \$18,000 for head of household filers, and \$12,000 for single filers and married taxpayers filing separately, all adjusted for inflation.

The elimination of the personal exemptions, and the significant increase in the standard deduction, were claimed to have been made in the interests of easing the burden of tax return preparation. Undoubtedly, more filers will be relying upon the standard deduction than in the past. For example, married, joint filers will need to be able to claim itemized deductions in excess of \$24,000 in 2018 (the amount of the standard deduction) to receive any benefit of those itemized deductions. With the significant limits now placed upon the deductibility of state and local taxes (\$10,000), many taxpayers who have itemized their deductions in prior years, will now discover that they are better off claiming the standard deduction. This means that there may be little or no income tax benefit from the charitable contributions you make, or the modest mortgage interest you might pay on your personal residence.

Suggested Planning Recommendation #1: Qualified Charitable Distribution: If you are over 70 ½ years of age and the owner of an IRA, you should think twice before you write a check for a charitable contribution. If you take your Required Minimum Distribution (“RMD”) you must recognize taxable income on that amount. However, due to the significantly increased standard deduction, you may not actually be itemizing your deductions in 2018 or future years. Thus, you will receive no tax benefit from the charitable contribution, but you would still be required to recognize the taxable income from the RMD. You should consider making a “qualified charitable distribution” (“QCD”) from the IRA directly to a public charity, which will be deemed to satisfy your RMD obligation dollar-for-dollar. This gives you the best of both worlds; you still receive the full standard deduction, but you have reduced your taxable income since the amount of the QCD is not taxable to you. The requirements for a QCD are straightforward: the donor may direct a transfer of up to \$100,000 of an IRA in any given year to a public charity, other than a donor-advised fund. Following the QCD, the amount transferred to the charity is not included in the donor’s federal taxable income and there is no charitable deduction.

For example, assume that in 2018 the donor is 70 ½ years old and married with \$100,000 of dividend and interest income and must take an RMD of \$20,000 from his IRA. The donor and his spouse will have \$96,000 of taxable income after taking the \$24,000 standard deduction. However, if instead the donor directs the IRA trustee to transfer the \$20,000 RMD directly to charity as a QCD, then the donor and spouse will have \$76,000 of taxable income (\$100,000 minus \$24,000 standard deduction). The RMD requirement will have been satisfied and the charity has still received \$20,000. The couple will have avoided tax on the \$20,000 RMD. The QCD is available only for IRAs, not SIMPLE IRAs or SEPs.

Suggested Planning Recommendation #2: Stacking Charitable Gifts: With the significantly increased standard deduction, you may not get a tax benefit from your charitable contributions. You should consider stacking several years-worth of gifts all into one year. Hypothetical: Assume a married couple has \$250,000 of taxable income from wages, and they usually make charitable gifts of \$7,500 per year. When they file their tax return in 2018, they calculate what their itemized deductions will be. They have a state and local tax deduction capped at \$10,000, a mortgage interest deduction of \$6,000, and a charitable contribution of \$7,500, for a total of \$23,500. Thus, they choose to use the standard deduction of \$24,000. Let’s assume they do exactly the same thing for the next five years. They will have made charitable gifts of \$37,500 and received no tax benefit at all.

Instead, what if they made a gift of \$37,500 to a Donor Advised Fund in 2018. A Donor Advised Fund is a charitable vehicle established at a public charity that allows donors to fund a large gift in any particular year, but distribute the funds among other charitable organizations well into the future. This will allow the couple to claim itemized deductions in the year 2018 in the amount of \$53,500 (\$10,000 + \$6,000 + \$37,500), thus reducing taxable income in 2018 to \$196,500 (with enhanced itemized deductions) vs. \$226,000 (with the standard deduction). This will reduce their income taxes significantly in 2018, and the couple can still claim the standard deduction in 2019 through 2022, while making \$7,500 distributions to their favorite charities from the Donor Advised Fund.

In other words, it makes sense to stack several years of charitable contributions into one year rather than making smaller contributions in several years, where there will be no tax benefit from those smaller gifts. In both examples, the couple has still given away \$37,500. If they do it over five years they receive no tax benefit, however, if they do it all in one year they have had significant tax savings.

The attorneys at Einhorn Barbarito are happy to discuss these and other available tax planning opportunities that can still be employed to reduce your income tax liabilities.

Please contact Einhorn Barbarito for any questions you have regarding the new tax law.