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Mitigating the new limit on home property tax deductions

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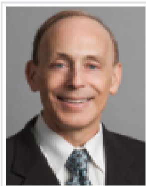

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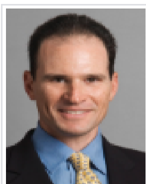

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One irritating aspect of the new tax law for Californians is the limit on the deductibility of state and local taxes. New Internal Revenue Code Section 164(b)(6), titled Limitation On Individual Deductions for Taxable Years 2018-2025, prevents an individual from deducting more than $10,000 of state and local taxes.

Assume Joe and Jane, a married couple, both lawyers, make $500,000 per year and live in a $1.5 million home (which is not subject to a mortgage). The combination of the California income tax ($40,000) plus the property tax ($18,000) puts them significantly over the $10,000 limit. Is there something they can do to mitigate the pain of the disallowed ($40,000 + $18,000 = $58,000 - $10,000 =) $48,000 of state taxes which, in a 35 percent federal bracket, costs them an extra $17,000 in federal tax?

The answer is a resounding "maybe."

Assume Joe and Jane have two children, ages 6 and 8. The parents should establish an irrevocable trust for their children's benefit. Most trusts established for estate tax planning purposes are grantor trusts, which are disregarded for income tax purposes. That is so that (i) sales by the parents to the trusts do not cause an income taxable gain; and (ii) the parents pay the income tax on the children's trust's taxable income, which is a type of gift tax free gift. The gift tax free gift is a way of reducing the parents' taxable estate on an on-going basis.

However, this children's trust will be taxed as a complex trust, meaning the trust will have its own taxpayer ID number, file its own income tax returns (IRS Form 1041 and California Form 541) and pay its own taxes. One distinct disadvantage of this type of trust is that it rapidly reaches the maximum 37 percent bracket: on $0 to $2,550 it is in the 10 percent tax bracket; at $2,551 minus $9,150 it pays $255 plus 24 percent of the amount over $2,550; on $9,151 minus $12,500 it pays $1,839 plus 35 percent of the amount over $9,150; and on $12,501 it pays $3,011.50 plus 37 percent of the amount over $12,500.

The parents should then transfer an undivided ($8,000 / $18,000 =) 44.44 percent interest in the home to the trustee of the new children's trust. The gift's value would be no more than ($1.5 million *x* 44.4 percent =) $666,600. In fact, if they choose to hire a business appraiser, the value is probably 30 percent less (meaning a gift of only $466,620) due to the fact that a tenancy in common interest is not worth as much as ownership of an entire piece of property by one individual. Since Joe and Jane have a combined $22.4 million lifetime transfer (estate, gift and generation skipping) tax exclusion, they probably have little or no incentive to spend the money on a business appraiser to save ($666,000 - $466,620 =) $200,000 of their exclusion.

The gift of an undivided interest in the residence to the new children's trust does not cause a reassessment for property tax purposes due to the unlimited parent-child exclusion for an interest in a principal residence. Revenue and Taxation Code Section 63.1(1)(A).

While the children are minors, the parents probably need not enter into a lease agreement with the trustee of the children's trust for their continuing use of the residence. However, once the children are no longer dependent upon the parents, a lease at fair market rent is required to keep the residence's value out of the parents' taxable estate for estate tax purposes. One possibility is that Joe and Jane do not care about estate taxes because they have a $22.4 million lifetime transfer tax exclusion, and they doubt that their estate will ever exceed that figure. If that is the case, then they need not enter into a fair market rent lease with the trustee of the children's trust (although that is still advisable if they wish to take the position, for creditor protection purposes, that they do not own that portion of the residence). Another possibility is that they care about estate taxes because they know that, as currently written, that exclusion will "sunset" back down to something like $13 million on Jan. 1, 2026. That is because all of the individual provisions of the new tax law must "sunset" at the end of 2025 to avoid having the new tax law's addition to the deficit exceed $1.5 trillion. In that case they will want to enter into a lease a fair market rent.

Another possibility is that Joe and Jane want to pay rent to the children's trust because they wish to take advantage of the lower trust income tax brackets on the first $12,501 of taxable income. As indicated above, on $12,501 a trust pays $3,011.50, which is 24 percent. Assume the home's fair rental value is $6,000 per month, or $72,000 per year. A fair market value lease between Joe and Jane and the trustee of the children's trust would be (44.4 percent *x* $72,000 =) $32,000 for a year. The trust's income tax return would look like this: $32,000 of rental income minus $8,000 of property taxes equals $22,000 on which the tax is $3,011.50 on the first $12,501 and 37 percent on the next $9,498.50 ($3,514,45) for a total tax of $6,525.95. That is a tax rate of ($6,525.95 / $22,000 =) 30 percent on the taxable income, but an effective tax rate of ($6,525.95 / $32,000 =) 20 percent given the availability of the mortgage deduction. That is an almost $4,700 improvement over the effective tax rate were the same $32,000 taxed at Joe and Jane's rate (35 percent or $11,200). Since Joe and Jane are going to be spending more than ($32,000 - ($6,525.95 + $8,000 =)) $17,474.05 on their children each year for decades, this is a nice savings for very little effort.

Joe and Jane have yet another approach to nibble away at their state and local tax deduction limitation problem. Internal Revenue Code Section 280A, entitled "Disallowance Of Certain Expenses In Connection With Business Use Of Vacation Homes, Etc." generally disallows deductions for a principal residence other than a deduction, like property taxes, which is deductible without regard to its connection to a trade or business or income-producing activity. Internal Revenue Code Section 280A(c) has an exemption for expenses attributable to the use of a portion of a dwelling unit "as the principal place of business for any trade or business of the taxpayer." The statute defines "principal place of business" to include "a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business." The legislative history clarifies that the deduction is available even where "administrative or management activities connected with [the taxpayer's] trade or business (e.g., billing activities) are performed by others at other locations." Bittker & McMahon, "Federal Income Taxation of Individuals," ¶13.10[2][a] (2nd 3d. 2002). "Others" appears to include employees, so a lawyer can allow staff to perform most of the genuine administrative work at the business office, allowing the lawyer to perform the remaining work at a qualifying home office. Wood, 547-3rd T.M., "Home Office, Vacation Home, and Home Rental Deductions," III.B.4(a)(2).

Assume Joe and Jane's home is 2,400 square feet. Assume they can set aside a room of 240 square feet to be used exclusively as a home office, e.g., preparing their bills each month. That means that 10 percent of the property tax -- or $1,800 -- can be allocated to the home office. Since it is allocable to a trade or business, it is no longer subject to the new law's $10,000 state and local tax limit. The savings: $1800 times 35 percent income tax bracket equals $630 per year.

In conclusion, the new law's $10,000 limit on the deduction of state and local taxes will inflict economic pain on many Californians. However, some will have opportunities to mitigate the damage through thoughtful planning.