Early Tax Returns Are Demonstrating the Importance of Tax-Exempt Income

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by Aquila Distributors of Aquila Group of Funds

Many Americans are anxious to find out what the Tax Cuts and Jobs Act of 2017 (TCJA) means for their 2018 filings, and early returns being filed now are giving us some clues. It appears that quite a few taxpayers will either be getting smaller refunds than last year, or may even be owing the government more money than they had in the past.

There were some very visible changes to tax law with the TCJA of 2017. One was the standard deduction increase which is now $12,000 for single filers, and $24,000 for married filing jointly – up from $6,350 and $12,700, respectively. While this may seem like a boon for most taxpayers who can now take almost double the standard deduction available in the previous year, the benefit has been dampened by another more visible tax law change – the State and Local Tax deduction limit, commonly referred to as the “SALT” deduction. The $10,000 cap on SALT deductions may not seem like a big deal at first, but the Personal Property Tax deduction – property taxes paid on homes, cars, boats, etc. – is no longer unlimited. This hits high-tax states such as New York, California, and Connecticut, among others, particularly hard. Taxpayers in these states may have been accustomed to deducting as much as two to three times the current cap for their property taxes alone. The SALT cap potentially puts many more families close to the standard deduction, where it may no longer make sense for them to itemize their taxes.

There were also some less-visible tax law changes that went into effect for the 2018 tax year. These are less talked about because of the current uproar over the SALT deduction limit. Two other homeowner-related deductions – home mortgage interest and mortgage insurance premiums – have been changed. Homeowners who took mortgages after December 15, 2017 can only deduct interest paid on a mortgage value up to $750,000 – the previous limit was $1,000,000. And the itemized deduction for mortgage insurance premiums has expired entirely.

Also now gone are the personal and dependent exemptions, which could be taken for yourself and each of your claimed dependents, at $4,050 per person. This has been replaced by a doubling of the child tax credit from $1,000 to $2,000, which does work out for most families on a federal level, but not all states have increased their child tax credit on a state tax level. This means that some families may no longer have the income deductions and may not be able to offset this loss on their state taxes. For example, a family with four children would have previously been able to take a $24,300 deduction from income (two parents, four children x $4,050 each), which would also have applied to their income on a state level. Now, in some states they may only get in the range of a $50-$100 per child tax credit. This will not come close to replacing the lost deduction.

Back in the beginning of 2018, many, but not all, taxpayers saw a bump in their paychecks, as a result of the federal tax cut portion of the TCJA. While the lowest four brackets, as well as the very highest bracket, saw their marginal tax bracket reduced – many “high earner” Americans actually saw an increase in their tax rate. This would be the case for many of the single or head of household filers making $157,500-$500,000 or those married filing jointly making $400,000-$600,000.

What does this all mean? For most Americans, it may signal a greater need to reduce their taxable income in order to offset tax law changes that will be affecting them for the current and future tax years. While this may be done in a variety of well-known ways such as contributing to 401(k)s, IRAs, HSAs and other tax-advantaged plans, it may also be advantageous to earn income that is exempt from federal and state taxes, such as income from state-specific municipal bond funds. It’s not only “high earners” who can benefit from tax-exempt municipal bond funds – they may be beneficial in any well-balanced investment portfolio. A recent article titled “Only Certainty is Death, Taxes, Muni Advantages” highlights this point and others related to TCJA outcomes.

The Aquila Group of Funds offers seven state-specific municipal bond funds, each with portfolio management teams located in the markets where they invest. Contact your financial advisor for more information.

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