Higher Income Taxpayers Hit with Exemption & Itemized Deductions Phaseout

Article Highlights:

- Phaseout Thresholds
- Personal Exemption Phaseout
- Itemized Deduction Phaseout
- Phaseout Example

Generally, in 2016 and 2017 taxpayers are allowed to deduct personal exemptions of $4,050 for themselves, their spouses and their dependents. In addition, taxpayers are allowed a standard deduction or, if their deductions are large, they can itemize their deductions.

However, the personal exemptions and itemized deductions for higher income taxpayers are phased out beginning when a taxpayer’s adjusted gross income (AGI) reaches a phaseout threshold amount.

The threshold amounts are based on the taxpayer’s filing status, and for 2017 they are $261,500 (up from $259,400 for 2016) for single filers, $287,650 (up from $285,350 for 2016) for individuals filing as heads of households, $313,800 (up from $311,300 for 2016) for married couples filing jointly and $156,900 (up from $155,650 for 2016) for married individuals filing separately. Here is how the phaseout works:

- **Personal Exemption** - The otherwise allowable exemption amounts are reduced by 2% for each $2,500 or part of $2,500 ($1,250 for a married taxpayer filing separately) that the taxpayer’s AGI exceeds the threshold amount for the taxpayer’s filing status.

  Example: *Ralph and Louise have an AGI of $426,300 for 2017 and two children for a total of four exemptions totaling $16,200 (4 × $4,050). The threshold for a married couple is $313,800; thus, their income exceeds the threshold by $112,500. Dividing $112,500 by $2,500 equals 45. So 90% (45 × 2%) of their $16,200 exemption allowance is phased out, leaving them with a reduced exemption deduction of $1,620 ((100%–90%) × $16,200). Assuming Ralph and Louise are in the 33% federal tax bracket, the phaseout costs them an additional $4,811 ($16,200 × 90% × 33%) of tax.*

  A divorced or separated parent subject to the phaseout should consider relinquishing the exemption of a dependent child to the other parent. Where a taxpayer is a party to a multiple support agreement, the taxpayer may want to allow another contributing member of the agreement who is not hit by the phaseout to claim the dependent’s exemption.

- **Itemized Deductions** - The total amount of itemized deductions is reduced by 3% of the amount by which the taxpayer’s AGI exceeds the threshold amount, with the reduction not to exceed 80% of the otherwise allowable itemized deductions.

  Not all itemized deductions are subject to phaseout. The following deductions are not subject to the phaseout:

o Medical and dental expenses
o Investment interest expenses
o Casualty and theft losses from personal-use property
o Casualty and theft losses from income-producing property
o Gambling losses

Thus, a taxpayer who is subject to the full phaseout still gets to deduct 20% of the deductions subject to the phaseout and 100% of the deductions listed above.

Example: *Ralph and Louise from the previous example, who had an AGI of $426,300 for 2017, exceed the threshold for a married couple by $112,500. Thus, they must reduce their itemized deductions subject to the phaseout by $3,375 (3% of $112,500), but the reduction must not exceed 80% of the deductions subject to the phaseout. For 2017, Ralph and Louise had the following itemized deductions:*

	Subject to Phaseout	Not Subject to Phaseout
Home Mortgage Interest	$10,000	
Taxes	$8,000	
Charitable Contributions	$6,000	
Casualty Loss		$12,000
TOTAL	**$24,000**	**$12,000**

The phaseout is the lesser of $3,375 or $19,200 (80% of $24,000). Thus Ralph and Louise's itemized deductions for 2017 will be $32,625 ($24,000 - $3,375 + $12,000). Assuming Ralph and Louise are in the 33% federal tax bracket, the phaseout will cost them an additional $1,114 ($3,375 × 33%) of tax.

Conventional thinking is to maximize deductions. However, where taxpayers normally are not subject to a phaseout and have a high-income year because of unusual income, it may be appropriate, where possible, to defer paying deductible expenses to the year following the high-income year or perhaps pay and deduct the expenses in the preceding year if the out-of-the-ordinary additional income is planned for in advance.

If you have questions about how these phaseouts will impact your specific situation, you want to adjust your withholding or estimated taxes, or you want to make a tax planning appointment, please give this office a call.