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Final Tax Reform Bill Bars Taxpayers from Prepaying State and Local Income Tax

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The final tax reform bill expected to pass this week not only curtails the deduction for state and local income taxes and property tax, but also eliminates individuals' ability to claim an itemized deduction by prepaying their 2018 state and local income taxes in 2017.

Both the U.S. House and Senate tax reform bills eliminated the deduction for state and local income taxes and capped the deduction for property tax at $10,000 per year. The conference agreement between the House and Senate would allow individuals to deduct up to $10,000 annually ($5,000 in the case of a married couple filing a separate return) of combined state and local (but not foreign) real property taxes; state and local personal property taxes; and state, local, and foreign income taxes. The $10,000 limit would not apply to any foreign income taxes or any state, local, or foreign real property taxes or any state or local personal property tax paid or accrued in carrying on a trade or business or a for-profit activity.

Because the tax reform bill was widely expected to eliminate or curtail the itemized deductions for state and local income taxes and property taxes, many tax advisors previously suggested that some individuals prepay their 2018 state and local taxes in 2017 in order to benefit from the full deduction one final time, particularly if they expected to be in a lower tax bracket in 2018. However, the final tax reform bill significantly limits that planning opportunity.

Under the text of the tax reform bill: “an amount paid in a taxable year beginning before January 1, 2018, with respect to a State or local income tax imposed for a taxable year beginning after December 31, 2017, shall be treated as paid on the last day of the taxable year for which such tax is so imposed.” As the conference committee report explains: “an individual may not claim an itemized deduction in 2017 on a prepayment of income tax for a future taxable year in order to avoid the dollar limitation applicable for taxable years beginning after 2017.” This provision was not in either the House or Senate tax reform bills and prevents individuals from deducting in 2017 prepayments of state and local income tax for a subsequent year.

Individuals may still claim a valid itemized deduction in 2017 for a payment of their remaining 2017 state income tax liability before December 31, 2017, assuming they are not subject to the Alternative Minimum Tax (AMT). Individuals may also still claim a valid itemized deduction in 2017 for a prepayment of property taxes due in 2018 – assuming, again, that the individual is not subject to the AMT.

Click here for further analysis of the recent House and Senate tax reform plans.

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