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The Tax Cuts and Jobs Act of 2017:

What You Need to Know

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The tax reform bill introduced by congressional Republicans as the Tax Cuts and Jobs Act of 2017 (the "Act") was signed into law by President Donald Trump on December 22, 2017. Versions of what would become the Act passed through Congress on a mostly party-line vote with only 51 Senators voting in favor of the legislation. This rewrite of the Internal Revenue Code has been projected to boost GDP, wages, and job growth at the expense of the federal deficit. The Act reduced tax rates for individuals and businesses, changed the landscape of individual deductions and credits, granted a new deduction for owners of pass-through entities, reduced the alternative minimum tax for individuals and eliminated it for corporations, limited the application of the estate tax by increasing the exemption for estate and gift taxes, and repealed the individual mandate of the Affordable Care Act. This newsletter will provide an overview of the changes under the Act, broken into three parts: estate taxation, individual taxation, and business taxation.

Estate and Gift Taxation under the Act: Increased Exemption and Portability

There had been much discussion about repealing the federal estate tax (often referred to as the "death" tax) over the course of the tax debate. The initial bill passed in the House of Representatives repealed the estate tax, while the initial bill passed in the Senate kept the estate tax but increased the exemption. Ultimately, the Act kept the estate tax while doubling the current exemption.

Increased Exemption Amount

Beginning in 2018, the basic exemption amount for estate and gift tax purposes of $5,000,000 is doubled to $10,000,000 and is indexed annually to account for inflation. The Act changed the formula that the Internal Revenue Service uses for indexing. The Service has not yet released its computation of the indexed exemption; however, it is likely to be $11,180,000 or a combined $22,360,000 for a married couple (it is applicable to decedents dying and gifts made after December 31, 2017). This amount is reduced by the amount of any lifetime gifts that exceed the annual exclusion. Similarly, an exemption of the same amount is available for transfers involving the generation skipping transfer tax (generally applicable to transfers involving grandchildren or more remote descendants). There were no changes to the estate, gift or GST rates. Thus, transfers in excess of the exemption remain subject to a maximum tax rate of 40%.

Portability Remains in Effect

Simply stated, portability allows a surviving spouse to claim the unused estate tax exemption of a deceased spouse and add it to the surviving spouse's own exemption. Thus, in 2018, if a timely portability election is made by the surviving spouse at the first spouse's

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passing, the surviving spouse may be able to have up to a $22,360,000 exemption. This can be applied to lifetime gifts by the surviving spouse or be used at the surviving spouse's passing. The election is made on a timely filed federal estate tax return for the estate of the first spouse to die, even if the first spouse's estate would not otherwise be required to file an estate tax return. However, there are many technical rules associated with making a portability election, and planning for the use of portability must be carefully reviewed.

<u>2026 Sunset</u>
In the absence of re-authorization, the increased exemption will sunset on December 31, 2025 resulting in a return to the $5,000,000 exemption that is indexed annually for inflation.

<u>Basis Adjustment of Capital Assets (often referred to as "stepped-up" basis)</u>
Appreciated assets continue to receive a new basis at death that often reduces capital gains that would otherwise be due when inherited property is sold. This does not apply to tax-deferred retirement plans, as distributions from those are treated as ordinary income. There had been much discussion about eliminating the basis adjustment at death in favor of a carryover basis regime, under which recipients of inherited property would take the decedent's basis in the property. However, the Act did not affect the existing basis adjustment rules. Taken together, the increased exemption and continuation of "stepped-up" basis means that a married couple can leave $22,360,000 in assets at death free of any estate tax or capital gains tax.

<u>What You Should Do Now</u>

- <u>Revisit Existing Estate Planning Arrangements.</u> Since the inception of the estate tax, estate tax planning for a married couple has centered on the use of formula-driven trusts that are designed to use the estate tax exemptions of both spouses before portability and increased exemptions were in effect. This approach was designed to shelter the first spouse's exemption, albeit at a cost of increased complexity in the plan and less favorable capital gains and income tax planning. Additionally, generation skipping provisions were often included to minimize the tax impact of an inheritance in a beneficiary's estate at some point in the future. In light of the increased exemption (even at the $5,000,000 level) and the permanence of portability, existing planning structures should be reviewed to determine their fitness for each particular situation.
- <u>Continue Making Portability Elections at the First Spouse's Death.</u> Again, given the lack of permanence for the increased exemption, a surviving spouse should still consider making a portability election at the first spouse's passing in order to claim the first spouse's exemption.
- <u>Continue Making Annual Exclusion Gifts.</u> Prior to the Act being signed, the IRS announced that the annual exclusion would be increased to $15,000 beginning in 2018. However, this adjustment could also be affected by the change to the indexing formula described above relative to the increased exemption. The annual exclusion is the amount that you can give each year without it being deemed a taxable gift. Note that any amount in excess of the annual exclusion does not necessarily result in tax being due. Rather the donor's exemption ($11,180,000) will be applied to the gift. The ability to give unlimited amounts directly to educational institutions or healthcare providers remains intact as the ability to contribute up to five times the annual exclusion to 529 Savings Plan.
- <u>Consider Making Taxable Gifts Now to Lock in the Increased Exemption.</u> As noted above, the increased exemption is temporary, with a scheduled sunset on December 31, 2025. Historically, it has been very rare for the estate tax exemption to drop down once it increased. In fact, it has only happened twice, 1932 and 1935. However, sunset of the increased exemption could happen. It is also possible for a future congress to pass legislation reducing the exemption. Thus, it may be advisable to make taxable gifts in 2018 to ensure the ability to use the increased exemption amount.

<u>Conclusion</u>
The increased exemption provided in the Act is a very significant development. However, the impact on your particular situation and what steps you should or should not take must be reviewed with your tax professional.

<u>Individual Taxes: Relief and Simplification</u>

Individual Tax Rates
The Act keeps the previous seven income tax brackets for taxpayers, but the income tax rates have been adjusted. The previous individual rates were 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%. The new brackets will be 10%, 12%, 22%, 24%, 32%, 35%, and 37%.

The marginal income tax thresholds for each filing status has also changed and can be found on this chart - https://taxfoundation.org/2018-tax-brackets/.

In addition to the tax rate changes, the Act eliminates the personal exemption and significantly increases the standard deduction to $12,000 for single individuals and $24,000 for joint filers. This significant increase in the standard deduction should reduce the number of taxpayers who itemize.

Relief for Families

Along with the near doubling of the standard deduction, the Child Tax Credit has been doubled from $1,000 per child to $2,000 per child. In addition, the amount that is refundable has increased from $1,100 to $1,400. There is also a new $500 non-refundable credit for dependents other than children. These credits phase out beginning at $200,000 for individuals and $400,000 for a married taxpayer.

Elimination or Reduction of Itemized Deductions

The increase in the standard deduction comes paired with the elimination of most itemized deductions. We will review some of the noteworthy changes. First, the Act eliminates the deduction for alimony starting in 2019. Therefore, any marital settlement agreement entered into after December 31, 2018, or a previously executed settlement agreement that is amended after December 31, 2018, that expressly provides for the new tax rules will be subject to the elimination of this deduction.

There has also been a change to charitable deductions. A taxpayer can now deduct up to 60% of their adjusted gross income ("AGI") for cash contributions to public charities and certain public foundations. This change is set to sunset in 2026 and the deduction amount will return to 50% of AGI.

The state and local tax deduction has been substantially scaled back. The law limits the amount of state and local property, income, and sales tax that can be deducted to $10,000. Previously, payment of taxes was fully deductible, but this new change will sunset in 2026. In a similar reduction, the law caps the home mortgage indebtedness deduction on new home purchases. The new law allows for the deduction of home purchase indebtedness of $750,000 down from the previous $1,000,000.00. Finally, there no longer is a deduction allowable for interest on home equity indebtedness.

The Act continues to allow for the itemized deduction of medical expenses. Under the Act, for 2018 you can deduct out-of-pocket medical expenses that exceed 7.5% of AGI. In 2019, the deduction will be back to the 10% threshold. The Pease limitation has also been repealed, which reduced the amount of a taxpayers itemized deductions if their AGI exceeded a designated threshold. The Act will also eliminate the itemized deduction for tax preparation fees and investment fees.

Other Noteworthy Changes

The Alternative Minimum Tax ("AMT") which has been a hot political topic over the last few years will remain on the books, although fewer taxpayers will be affected by it. The burden of the AMT has been reduced by raising the exemption to $109,400 for married and $70,300 for individuals. This is up from $84,500.00 and $54,300.00 respectively. The phase-out of this exemption has also increased from previous years to $500,000 for individuals and $1,000,000for joint returns up from $120,700.00 for individuals and $160,900 for joint returns last year.

In another bit of good news, allowable withdrawals for 529 plans, which allow for the tax-free growth and withdrawals for college expenses, have expanded. In addition to withdrawals for college expenses, you will also be able to withdraw $10,000 per year, per child, to pay for private and religious schools (grades K-12). Also, families with members who have a disability can roll over a 529 plan to ABLE accounts which offer certain tax advantages.

There has also been a change to the Kiddie Tax. Currently if a child has unearned income, the unearned income is taxed at their parents' tax rates if the parents' rates are higher than the child's. Under the Act, the tax rates of a child's unearned income would be taxed using the brackets that a trust or estate would follow. If the parents' were at the highest tax rate, this would be of little consequence. If the parents' are in the middle tax brackets, the increase could be substantial.

Finally, there has been a repeal of the insurance mandate under the Affordable Care Act. Previously, individuals were required to purchase a qualifying health insurance plan or pay a penalty. Under the Act, starting in 2019, the penalty will be reduced to zero.

Conclusion

Although the effect to individual taxpayers based on this law will be based on each individual's situation, we do see some general winners and losers. Because of the higher standard deduction and the reduction of the state and local income tax deduction, wage earners from no-income-tax states will see tax savings under this law. Conversely, wage earners from income tax states may see a tax increase with this law. As with any new legislation, we would suggest you contact your tax professional to determine any tax advantages that can be obtained from this Act.

The New Act and Business Entities: Benefits Abound

Primer on Business Entities and Terminology

The Act made significant changes to the taxation of business entities, including a large reduction in the top corporate tax rate and a new deduction for individuals receiving qualified business income from a pass-through entity. If you operate a business there are four main entity classifications for tax purposes: a C corporation, an S corporation, a disregarded entity (such as a sole proprietorship that reports income on the owner's individual tax return), and a partnership. The term "corporation" as used in this newsletter shall only mean a C corporation which is subject to double taxation: income is first taxed at the business level and then is taxed again upon being distributed to the shareholders (i.e. dividends). The term pass-through entity means a business that generally does not pay tax at the entity level but is instead taxed at the individual owner level, such as an S corporation, partnership, or a disregarded entity. A detailed discussion of entity taxation is beyond the scope of this newsletter but a basic understanding of corporations and pass-through entities is key to understanding the changes affecting businesses in the Act.

Changes for all Businesses: Early Expensing

Corporations and pass-through entities will be able to deduct the full cost of acquiring depreciable property in the year it is acquired. This 100% deduction replaces the 50% "bonus" first-year depreciation effective before the Act. Property eligible for "bonus" depreciation previously included most new tangible property and now also includes used property but does not include real property and certain improvements to buildings. The 100% deduction is only available if the property is acquired and placed in service after September 27, 2017 and before January 1, 2023 and will be phased-out by 20% per year from 2023 until 2027 when this early expensing deduction no longer applies.

Tax Cuts for Corporations

Corporations were the big winners under the Act. Most notably, the top corporate tax rate was permanently reduced from 35% to 21%. The Act also repealed the alternative minimum tax for corporations. This drastic change makes corporations much more appealing for tax purposes even in light of the changes to pass-through entities discussed below.

New Deduction for Qualified Business Income: Section 199A

Starting January 1, 2018 and slated to "sunset" in 2026, owners of pass-through entities may be eligible for a 20% deduction under a new Section 199A, subject to many limitations. Section 199A was added as a new deduction for owners of pass-through entities which generate "qualified business income" and also allows a 20% deduction for qualified REIT dividends and qualified publicly traded partnership income.

- Qualified Business Income: For purposes of Section 199A, "qualified business income" is essentially ordinary income less ordinary deductions generated by a "qualified trade of business" but does not include wages the owner earned (or was deemed to earn) as an employee or certain investment income. While we wait for regulations and further clarification on this deduction there is some uncertainty about what types of business activities rise to the level of a "qualified trade or business" to be eligible for this deduction.
- Section 199A Deduction – The W-2 Wage Limitation for High Income Owners: The Section 199A deduction is subject to the "W-2 Wage Limitation" once the owner's taxable income reaches the "threshold amount" ($315,000 for married filers and $157,500 for all others). As the owner's taxable income increases above the threshold amount and until it reaches $415,000 for married filers and $207,500 for all others, the amount of the deduction is increasingly subject to the W-2 Wage Limitation. Under the W-2 Wage

Limitation, the Section 199A deduction is limited to the greater of 1) 50% of the owner's share of "W-2 wages" paid by the business, or 2) 25% of the owner's share of "W-2 wages" paid by the business plus 2.5% of the owner's share of the "unadjusted basis" of qualified property.

- Specified Service Trade or Businesses: In addition to the W-2 Wage Limitation, taxpayers with taxable income in excess of the threshold amount from above who receive qualified business income from a "specified service trade or business" begin to see a reduction in their Section 199A deduction. The deduction continues to decrease as taxable income increases until the taxable income exceeds $415,000 for married filers and $207,500 for all others. Above this limit the Section 199A deduction is not available to taxpayers receiving qualified business income from a specified service trade or business. The 20% Section 199A deduction is not reduced where the taxpayer has taxable income below the threshold amount. The definition of "specified service trade or business" includes health, law, accounting, actuarial science, consulting, investing, and investment management. Architects and engineers are specifically excluded from the definition of specified service trade or business.
- Non-Capital Gain Income Limitation: After calculating the limitations outlined above, the overall Section 199A deduction is limited to the lesser of: 1) the "combined qualified business income;" or 2) 20% of non-capital gain income. The "combined qualified business income" is the potential deduction for qualified business income as described above added to the deductions for qualified REIT dividends and qualified publicly traded partnership income. The non-capital gain income is the owner's taxable income less the owner's net capital gain. This limitation ensures that the taxpayer is not getting a double-benefit on capital gain income (which is already taxed at preferential rates) by reducing taxable income by capital gain income so that only the excess is eligible for the 20% deduction.

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[1] Scott A. Hodge, Statement on Final Passage of the Tax Cuts and Jobs Act (Dec. 20, 2017), The Tax Foundation, https://taxfoundation.org/statement-final-passage-tax-cuts-jobs-act/

[2] Keith Hall, Director, Congressional Budget Office, Distributional Analysis of the Tax Cuts and Jobs Act, as Ordered Reported by the Senate Committee on Finance on November 16, 2017, Excluding the Effects of Eliminating the Individual Mandate Penalty (November 27, 2017), https://www.cbo.gov/publication/53349;

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