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Special Tax Issue

JANUARY 2018

New Tax Act Makes Sweeping Changes to Individual Taxes

The 2017 Act made the most significant changes to the U.S. tax code in over 30 years, impacting virtually every individual and business. Due to political constraints and Senate budget rules, most of the individual provisions became effective in 2018, but revert to prior law before 2025. While there are numerous provisions impacting individuals, some of the most significant include:

- **Individual Income Tax Rates** — While there are still seven tax brackets for individuals, the ordinary income tax rates have decreased to 10%, 12%, 22%, 24%, 32%, 35%, and 37% (compared to 10%, 15%, 25%, 28%, 33%, 35% and 39.6% under prior law) and the income brackets have widened. See the article "2018 Tax Brackets under Prior Law and 2017 Act" on page 4 for more details. In future years, income levels will be indexed for inflation using a chained consumer price index (CPI). The IRS estimates that taxpayers will start to see the effects of these reductions in their paychecks as early as February 2018. The Tax Foundation estimates that the 2017 Act will increase the after-tax incomes of all taxpayer groups in 2018 by 0.8% to 2.2% (Source: *Preliminary Details and Analysis of the Tax Cuts and Jobs Act*, December 2017).
- **Qualified Dividends and Capital Gains** — The tax rates on net capital gains and qualified dividends remain, but the brackets for the different tax rates are indexed for inflation using the chained CPI-U.
- **Chained CPI-U** — As mentioned above, the income levels subject to taxation as well as many other provisions in the 2017 Act are adjusted for inflation using a chained CPI-U rather than the CPI-U, which had been used in the past. Typically, chained CPI-U grows at a slower rate than regular CPI-U, since it considers substitute purchases in reaction to changes in relative prices. Many feel that CPI-U overstates increases in the cost of living because it doesn't account for the fact that consumers adjust their buying patterns when prices increase, instead of simply buying the same item at a higher price.
- **Standard Deduction** — The standard deduction nearly doubled to $24,000 for married couples filing jointly, $18,000 for head of household filers, and $12,000 for single individuals, indexed for inflation using the chained CPI-U. Under prior law, the 2018 standard deduction was $13,000 for married couples filing jointly, $9,550 for heads of households, and $6,500 for single filers. This change simplifies tax filing by reducing the number of individuals who itemize deductions by 50%. Approximately nine out of 10 taxpayers will simply claim the new standard deduction starting in 2018 (Source: The Heritage Foundation, December 19, 2017).
- **Personal Exemption Deduction** — The deduction for personal exemptions and the personal exemption phaseout has been eliminated through 2025.
- **Child Tax Credit** — The 2017 Act increases the child tax credit from $1,000 to $2000 per qualifying child, with up to $1,400 being refundable. The adjusted gross income phaseout thresholds are increased to $400,000 for married couples filing jointly (up from $110,000) and $200,000 for all other filers (up from $75,000 for single filers and $55,000 for married individuals filing

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New Tax Act

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separately), which is not indexed for inflation. A $500 nonrefundable credit is also available for qualifying dependents other than qualifying children.

❍ **State and Local Tax Deduction** — Deductions for state and local taxes, including income taxes and property taxes, are limited to $10,000 ($5,000 for married individuals filing separately). Sales taxes can be claimed as an alternative to state and local income taxes. Prepayment of state and local income taxes in 2017 for a future year is disallowed.

❍ **Mortgage Interest Deduction** — The mortgage interest deduction is limited to interest on $750,000 of acquisition debt ($375,000 for married individuals filing separately). If the debt was incurred prior to December 15, 2017, the prior limitation of $1 million remains ($500,000 for married taxpayers filing separately). Taxpayers can still include mortgage interest on second homes within the lower dollar caps. Interest on home-equity loans is no longer tax deductible.

❍ **Charitable Contribution Deduction** — The 50% limitation for contributions to public charities and certain private foundations has been increased to 60% of the taxpayer's contribution base. Contributions exceeding the 60% maximum can be carried forward and deducted for up to five years.

❍ **Medical Expense Deduction** — For tax years beginning after December 31, 2016, and ending before January 1, 2019, medical expenses in excess of 7.5% of adjusted gross income (AGI) for all taxpayers can be deducted (down from 10% of AGI for all taxpayers except those over age 65).

❍ **Personal Casualty and Theft Loss Deduction** — Itemized deductions for personal casualty losses, including those from fire, storms, shipwrecks, other casualties, and thefts, are suspended, except for personal casualty losses incurred in a federally declared disaster.

❍ **Alimony Deduction** — For divorce agreements entered into after December 31, 2018, alimony and separate maintenance payments are not deductible by the paying spouse and not included in income of the spouse receiving the payments.

❍ **Miscellaneous Itemized Deductions** — The deduction for miscellaneous itemized deductions in excess of 2% of AGI is suspended.

❍ **Limitation on Itemized Deductions** — Under prior law, itemized deductions for higher-income taxpayers were limited (known as the Pease limitation). For taxpayers who exceeded the threshold amount, itemized deductions were reduced by 3% of the amount AGI exceeded the threshold. Under the 2017 Act, the Pease limitation is suspended.

❍ **Affordable Care Payment** — The individual shared responsibility payment required under the Affordable Care Act (also known as Obamacare) is permanently reduced to zero, effective for months beginning after December 31, 2018. However, both the 3.8% net investment income tax and the 0.9% additional Medicare tax, which were enacted as part of Obamacare, remain in effect.

❍ **Kiddie Tax** — A child's earned income is now taxed at the rates for single individuals and net unearned income is taxed based on the brackets for trusts and estates (see the article "Estate- and Gift-Tax Exclusion Doubled" on page 4 for more details on those rates). Under prior law, the child's net unearned income was taxed at the parents' rate if that rate was higher than the child's tax rate, while the remainder of the child's income (earned income plus unearned income up to $2,100 in 2018 less the child's standard deduction) was taxed at the child's rate.

❍ **Section 529 Funds** — The definition of qualified higher education expenses that can use Section 529 account funds has been expanded to include tuition at an elementary or secondary public, private, or religious school, up to a $10,000 per year limit.

❍ **Recharacterization of IRA Contributions** — Under prior law, both regular contributions and conversion contributions to a Roth IRA could be recharacterized as having been made to a traditional IRA. The 2017 Act no longer allows recharacterization of conversion contributions to a Roth IRA, although the other recharacterizations are available.

❍ **Alternative Minimum Tax (AMT)** — The AMT is a separate tax calculation meant to prevent high-income taxpayers from avoiding tax liability by using exclusions, deductions, and credits to reduce income. If the AMT tax is higher than the regular tax, the larger amount is owed. When computing the AMT, only income above an AMT exemption amount is considered. Under the 2017 Act, the exemption amount has been increased to:

— $109,400 for married taxpayers filing jointly and surviving spouses (up from $86,200)

— $70,300 for single taxpayers (up from $55,400)

— $54,700 for married taxpayers filing separately (up from $43,100)

These exemption amounts are reduced (not below zero) to 25% of the amount by which the taxpayer's income exceeds the phaseout amounts:

— $1 million for married taxpayers filing jointly and surviving spouses

— $500,000 for all other taxpayers

All amounts will be adjusted for inflation based on the chained CPI-U. ❍❍❍

2017 Act Provides Major Changes for Businesses

The most significant changes of the 2017 Act were to the taxation of businesses. While most of the changes for individuals are effective from 2018 to 2025, most changes for businesses are permanent. It is anticipated that the reforms to the business tax code will provide a significant boost to the U.S. economy by attracting international business investment and jobs. Estimates indicate that the economy could grow an additional 2.6% to 2.8% over the long term due to these changes.

Some of the more significant changes enacted for businesses include:

❍ **Corporate Tax Rate** — For tax years beginning after December 31, 2017, the corporate tax rate is a flat 21%. Under prior law, corporations were subject to graduated tax rates of 15%, 25%, 34%, and 35%. Personal service corporations were subject to a 35% rate on all taxable income. While this is a significant reduction in tax rates, the cumulative rate for businesses when adding average state taxes is approximately 26%, still higher than the worldwide average of 23% (Source: The Heritage Foundation, December 19, 2017).

❍ **Dividends Received Deduction** — Under prior law, corporations that receive dividends from other corporations received a deduction of 80% if the corporation owned at least 20% of the stock. Otherwise, the deduction was 70%. Under the 2017 Act, the percentages are now 65% and 50%, respectively.

❍ **Alternative Minimum Tax (AMT)** — Under the 2017 Act, the corporate AMT is repealed.

❍ **Pass-Through Deduction** — Partnerships, S corporations, limited liability companies, and sole proprietorships are pass-through entities. Their income is not taxed at a corporate level, but is passed through to the owners and taxed on their individual returns at individual income tax rates. Starting in 2018, a 20% deduction reducing taxable income of certain non-salary business income will be available to these owners. Certain service providers in the fields of law, health, consulting, athletics, financial, and brokerage services are denied the deduction if their income exceeds a $315,000 threshold, where the deduction starts to phase out.

❍ **Bonus Depreciation** — The 50% bonus depreciation allowance is increased to 100% for property placed in service after September 27, 2017, and before January 1, 2023. Bonus depreciation can now be utilized on the purchase of used property. After January 1, 2023, the bonus depreciation reduces to:

— 80% for property placed in service in 2023,

— 60% for property placed in service in 2024,

— 40% for property placed in service in 2025, and

— 20% for property placed in service in 2026.

❍ **Section 179 Expensing** — For tax years beginning after December 31, 2017, the maximum Section 179 amount that can be expensed is increased to $1 million (up from $500,000), which is reduced by the amount by which the cost of qualifying property exceeds $2.5 million (up from $2 million). These amounts are indexed for inflation after 2018.

❍ **Automobile Depreciation** — Starting after December 31, 2017, the cap on depreciation write-offs of business-use vehicles for which the additional first year depreciation deduction is not claimed is $10,000 for the first year (up from $3,160), $16,000 for the second year (up from $5,100), $9,600 for the third year (up from $3,050), and $5,760 for each subsequent year (up from $1,875). The limitations are indexed for inflation.

❍ **Interest Deduction** — The deduction for net interest expenses is capped at 30% of adjusted taxable income.

❍ **Net Operating Losses (NOLs)** — NOLs will be limited to 80% of taxable income for losses in tax years beginning after December 31, 2017. NOLs can no longer be carried back in most cases, but there is an indefinite carryforward period.

❍ **International Income** — The 2017 Act only taxes corporate income earned in the U.S. by allowing an exemption for dividends from foreign subsidiaries. A one-time transition tax on accumulated overseas profits is assessed at 15.5% of liquid assets and 8% of reinvested foreign earnings.

❍ **Other Corporate Provisions** — Numerous business tax preferences were eliminated, including the section 199 domestic production activities deduction and non-real property like-kind exchanges. Rules for business meals and the rehabilitation credit were revised. The research and development credit remains, but requires a five-year amortization of research and development expenditures. A temporary credit is now available for employers who pay employees on family and medical leave. ❍❍❍

Estate- and Gift-Tax Exclusion Doubled

While there was strong support for outright appeal of the estate tax, the 2017 Act retained the estate tax, but doubled the estate- and gift-tax exclusion amount. New income tax rates and brackets were also enacted for estates and trusts.

Under prior law, the estate- and gift-tax exclusion amount was $5 million, adjusted for inflation in years after 2011. For 2018, the amounts were $5.6 million per individual or $11.2 million for a married couple. Thus, transferred property under those assets was exempt from estate and gift taxes.

Starting in 2018 through 2025, the 2017 Act doubles the estate- and gift-tax exclusion amount from $5 million to $10 million. The $10 million amount is indexed for inflation after 2011 and is expected to be approximately $11.2 million for an individual in 2018 or $22.4 million for a married couple. Generation-skipping transfers are not mentioned in the 2017 Act. However, since the generation-skipping transfer tax exemption is based on the estate- and gift-tax exclusion amount, generation-skipping transfers will also be increased to these amounts.

Beneficiaries still receive a step up in basis as of the date of death for inherited assets for purposes of subsequent sales.

The tax rates for estates and trusts in 2018 are:

10%	$0–$2,550
24%	$2,551–$9,150
35%	$9,151–$12,500
37%	Over $12,500

Under prior law, the maximum tax rate for estates and trusts was 40%. ❍❍❍

2018 Tax Brackets under Prior Law and 2017 Act

Married Filing Jointly

Prior Law Rate	Prior Law Income Bracket	2017 Act Rate	2017 Act Income Bracket
10%	$0–$19,050	10%	$0–$19,050
15%	$19,051–$77,400	12%	$19,051–$77,400
25%	$77,401–$156,150	22%	$77,401–$165,000
28%	$156,151–$237,950	24%	$165,001–$315,000
33%	$237,951–$424,950	32%	$315,001–$400,000
35%	$424,951–$480,050	35%	$400,001–$600,000
39.6%	Over $480,050	37%	Over $600,000

Single

Prior Law Rate	Prior Law Income Bracket	2017 Act Rate	2017 Act Income Bracket
10%	$0–$9,525	10%	$0–$9,525
15%	$9,526–$38,700	12%	$9,526–$38,700
25%	$38,701–$93,700	22%	$38,701–$82,500
28%	$93,701–$195,450	24%	$82,501–$157,500
33%	$195,451–$424,950	32%	$157,501–$200,000
35%	$424,951–$426,700	35%	$200,001–$500,000
39.6%	Over $426,700	37%	Over $500,000

Please Call

The 2017 Tax Cuts and Jobs Act (2017 Act) was signed into law by the president on December 22, 2017. The 2017 Act provides the most significant tax changes in over 30 years. The articles in this newsletter cover major provisions in the 2017 Act in the areas of individual taxes, estate taxes, and business taxes. Due to its sweeping nature, there are many more provisions in the 2017 Act that may apply to individual situations. Please call if you'd like to review your situation to determine how specific provisions may impact you. ❍❍❍

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