# TAX CUTS AND JOBS ACT SUMMARY

**What Every Financial Professional Needs to Know**

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# OVERVIEW

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act, arguably the most comprehensive piece of tax reform since the Bush era tax cuts circa 2001-2003. The expressed goal was to simplify a complex tax system. By the time the legislation made its way through the House and the Senate and became law, the reconciled final bill didn't quite hit the mark on that goal in some respects but, in others, the new tax code made definite headway. Most of the provisions take affect in 2018 and, the majority of those impacting individual taxpayers, incorporate a sunset provision and revert to pre-existing law in 2026. Whether these provisions expire in 2025 remains to be seen but, for now, planning considerations should be made under the assumption that they will. Conversely, changes affecting corporations were made permanent.

What follows is a summary of the critical components of the Tax Cuts and Jobs Act (TCJA). Because we are still within the infancy stages of this bill, it is likely that it will take months and perhaps years for planners to completely analyze new strategies that will help your clients and prospects leverage the benefits and perhaps mitigate the provisions that may impact them negatively compared to the pre-TCJA version of tax law. One thing is for certain, however. Your awareness of the key pieces of the legislation will help you to empower your clients with the knowledge to make informed decisions regarding their own situations. It goes without saying that encouraging your clients to consult with their tax advisor before adopting a course of action is critical.

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# INDIVIDUAL REFORM UNDER TCJA[i]

## *Individual Income Tax Rates:*

While early versions of the bill proposed a reduction from the seven-bracket structure down to three, the final version maintained seven rates, albeit reduced in most cases. Pre-TCJA marginal tax brackets were 10%, 15%, 25%, 28%, 33%, and a top rate of 39.6%, the new rates are 10%, 12%, 22%, 24%, 32%, 35% and a top rate of 37%. It is expected that most taxpayers will experience a reduction in taxes because of this modification, at least through the expiration of the sunset period. Five filing statuses remain unchanged at single, married filing jointly, head of household, married filing separately, and estate and trusts. Estates and trusts moved from five to four rates of 10%, 24%, 35%, and a maximum rate also of 37% that is reached when income exceeds $12,500 in 2018[1]. These provisions are set to expire on 12/31/25.

## *Inflation Adjustments:*

Prior to TCJA, the Consumer Price Index for All Urban Workers (CPI-U) was the standard benchmark for measuring inflation. Effective in 2018 and made permanent, CPI-U is replaced with the Chained Consumer Price Index for All Urban Workers (C-CPI-U), a measure that also considers substitutions consumers make in response to changing prices and is believed to be a more accurate representation of inflation[2]. The chained index is more likely to inflate at a slower rate and therefore could create “bracket creep”, or the movement into a higher marginal bracket more quickly as taxable income increases.

## *Modification to Kiddie Tax:*

Effective in 2018 through the end of 2025, unearned income of children (generally, those under age 19 or age 24 if full-time college students) above a modest threshold ($2,100 in 2018) will be taxed using the marginal tax rates that apply to estates and trusts rather than the highest marginal tax bracket of their parent(s). A child’s earned income continues to be taxed at his/her individual tax bracket[3].

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## *Increase in Standard Deduction:*

One of the goals of the proposed versions of the legislation was to significantly increase the standard deduction, thereby making it easier for individuals to file a simplified tax return and eliminating the need or desire to itemize deductions. The final bill substantially increased the standard deductions by almost doubling their pre-TCJA amount. For single and married filing separately taxpayers, the limit was increased from $6,350 (2017) to $12,000; for married filing jointly taxpayers, the limit increased from $12,700 in 2017 to $24,000 and, for Head of Household filers, from $9,350 to $18,000. The additional standard deduction for blind taxpayers and those 65 or older increases to $1,300 in 2018[4]. Approximately 30% of taxpayers itemize deductions; however, it is projected that estimate will increase to roughly 90% of taxpayers under these changes.

## *Suspension of Personal Exemptions:*

Broadening the scope of the standard deduction didn't come without casualties. Through the end of 2025, the personal exemption is suspended[5]. Prior to TCJA, the personal exemption per eligible family member was $4,050 so, for example, a family of five could take a $20,250 deduction in addition to the standard deduction. The drastic increase of the standard deduction under the legislation won't be enough to make up for the loss of personal exemptions for some families; however, the modification to the child tax credit, combined with the almost doubling of the standard deduction, will likely make up the difference in most cases.

## *Expanded Child Tax Credit:*

While the personal exemption was suspended through the end of 2025, the child tax credit was doubled from its former $1,000 in 2017 to $2,000 through the end of 2025. Perhaps even more beneficial to the increased credit amount was the widening of the income thresholds to allow for more taxpayers with eligible dependents, children under the age of 17, to take advantage of the credit. Prior to TCJA, the income phaseouts of $75,000 (individual) and $110,000 (married) made it difficult for some families to take full advantage of the credit. The TCJA substantially increased the phaseouts to $200,000 and $400,000 for individuals and married couples filing jointly, respectively. The bill also increases the refundable amount of the credit from $1,000 to $1,400. A new non-refundable credit of $500 for "non-qualifying" dependents was also added which would include full-time college students under the age of 24 and parents who are claimed as dependents[6]. The fact that the child tax credit is a dollar for

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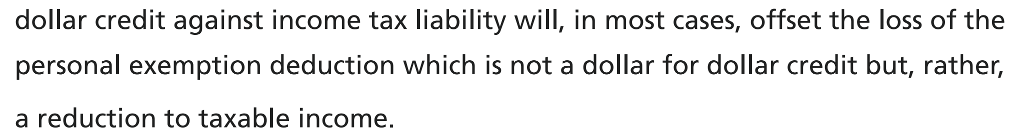

dollar credit against income tax liability will, in most cases, offset the loss of the personal exemption deduction which is not a dollar for dollar credit but, rather, a reduction to taxable income.

## *Limitation on S.A.L.T. Deductions:*

Prior to TCJA, a taxpayer could deduct state and local income, sales and property taxes with no limit other than choosing whether to deduct state and local income tax or state and local sales tax. The legislation now caps the combined deduction of state and local income, sales, and property taxes to $10,000 or $5,000 for married couples filing separately. Married couples filing jointly will also be limited to $10,000 total[7]. Original versions of the bill would have eliminated the deduction entirely. Taxpayers in high state income and property tax states are likely to feel this change disproportionately compared to taxpayers in other states through the expiration of the sunset period in 2025.

## *Limitation on Home Mortgage Interest:*

Effective 2018, the interest deduction is limited to debt acquisition indebtedness of $750,000, down from $1,000,000 in 2017. Mortgages in place prior to December 16, 2017 are grandfathered to the higher limit as are homes that were under binding contract by December 15, 2017 and closed no later than April 1, 2018. Conversely, the ability to deduct interest for home equity indebtedness is repealed as of January 1, 2018 and no such grandfathering provision exists meaning interest on existing home equity loans used for any purpose other than to acquire, construct or substantially improve upon a residence as defined under IRC §163(h)(3) will no longer be deductible. Both modifications are effective through December 31, 2025[8]. Since it will be the taxpayer's responsibility to prove that funds from a home equity loan were used expressly for the purpose acquiring, constructing, or improving upon a home, it is critical that taxpayers maintain accurate records.

## *Suspension of Miscellaneous Itemized Deductions:*

The bill also temporary suspended, through the expiration of the sunset period, itemized deductions subject to the 2% of Adjusted Gross Income floor. Deductions that fall into this category include tax preparation and legal fees, investment advisory fees, fees to fight the IRS, gambling losses, and unreimbursed employee business expenses such as travel, meals, professional dues, and entertainment[9]. It is important to note that business expenses for this purpose are excluded only for W-2 employees and not those that are self-employed and have a bona fide business.

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## *Alimony Deduction Repealed:*

A surprising twist was a permanent repeal of the alimony deduction that historically afforded the payer to deduct the annual amounts paid under a divorce or separation agreement. Effective with agreements executed after December 31, 2018, payments will no longer be deductible by the payer nor included as income to the payee. Modifications to existing agreements after this date will still be grandfathered under the rules prior to TCJA unless the modified agreement expressly states that the provisions made under the Act apply.

## *Suspension of Exclusion or Deduction of Moving Expenses:*

Effective January 1, 2018 through the end of the sunset period, moving expenses that were previously reimbursed by an employer and excluded from income will now be includable in gross income except for active military personnel subject to a military order or because of a permanent change of station. Moving expenses will also no longer be deductible other than by military personnel under the same definition[10].

## *Other Temporary Expansions and Important Changes for Individual Taxpayers:*

1. Limitation to cash donations to qualified public charities is increased from 50% of AGI to 60% of AGI[11]. Charitable lumping may be a good strategy to use in alternating years to perhaps provide for a higher itemized deduction in some years and the standard deduction in others. The higher limit may also allow for a quicker release of carryover donations that were capped under the prior 50% limit. Effective Date: 2018-2025.
2. The medical expense deduction floor is temporarily reduced for all taxpayers to medical expenses greater than 7.5% of AGI[12]. Generally, taxpayers under age 65 are limited to a deduction of medical expenses that exceeded 10% of AGI. Effective Date: Retroactive 01/01/17 – 12/31/18. Taxpayers who experienced high medical expenses in 2017 or will in 2018 should take advantage of this temporary reduction, particularly on their 2017 taxes and in 2018, if the expenses allow them to exceed the higher standard deduction by itemizing.

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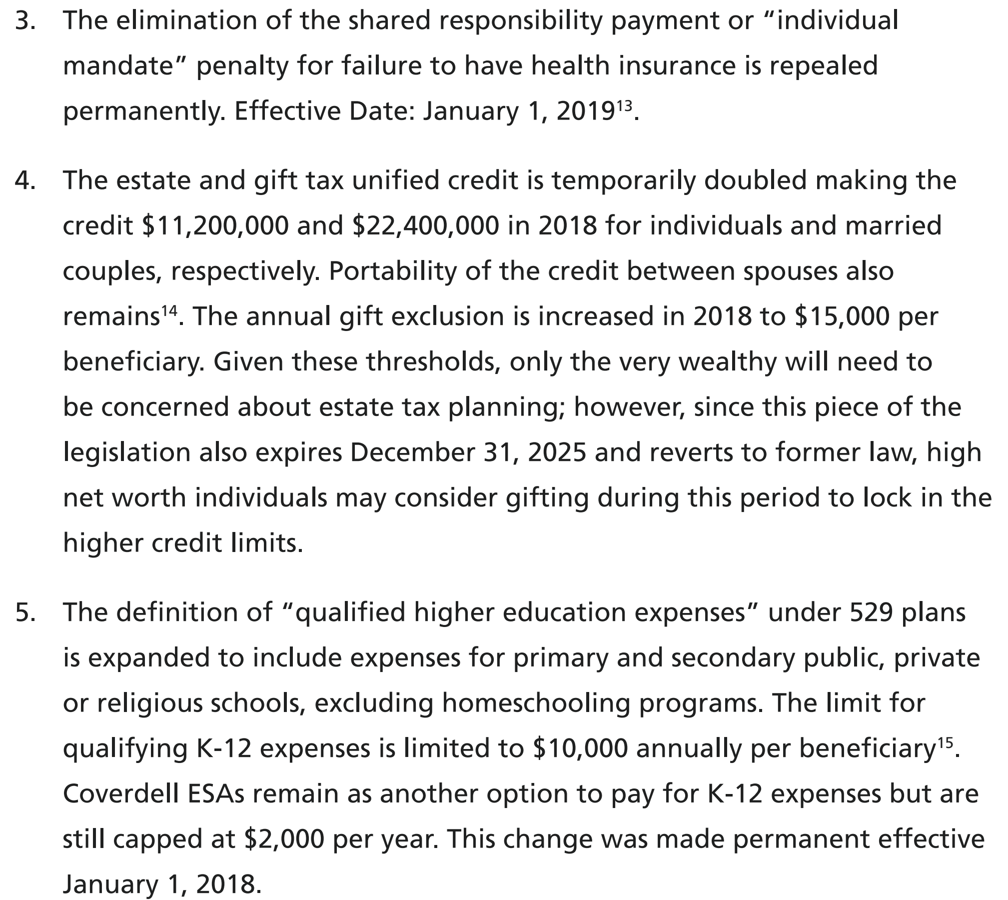

3. The elimination of the shared responsibility payment or "individual mandate" penalty for failure to have health insurance is repealed permanently. Effective Date: January 1, 2019[13].

4. The estate and gift tax unified credit is temporarily doubled making the credit $11,200,000 and $22,400,000 in 2018 for individuals and married couples, respectively. Portability of the credit between spouses also remains[14]. The annual gift exclusion is increased in 2018 to $15,000 per beneficiary. Given these thresholds, only the very wealthy will need to be concerned about estate tax planning; however, since this piece of the legislation also expires December 31, 2025 and reverts to former law, high net worth individuals may consider gifting during this period to lock in the higher credit limits.

5. The definition of "qualified higher education expenses" under 529 plans is expanded to include expenses for primary and secondary public, private or religious schools, excluding homeschooling programs. The limit for qualifying K-12 expenses is limited to $10,000 annually per beneficiary[15]. Coverdell ESAs remain as another option to pay for K-12 expenses but are still capped at $2,000 per year. This change was made permanent effective January 1, 2018.

# MODIFICATIONS AFFECTING RETIREMENT PLANS

## *Repeal of Recharacterization of Roth Conversions:*

One major change under the Act repeals the ability to recharacterize a Roth conversion executed after December 31, 2017[16]. Under prior law, a conversion to a Roth IRA could be essentially undone to avoid the tax liability on the converted amount provided the recharacterization back to the original IRA was done by October 15 and included any earnings on the converted amount. This allowed taxpayers who experienced losses since the original conversion to avoid paying taxes on the higher conversion amount or those whose tax picture changed and made it difficult to afford the taxes due on the conversion. It is important to note that recharacterization of IRA contributions made to either a Roth IRA or a traditional IRA were not impacted by this change. An IRA contribution, for example, may still be recharacterized to a Roth IRA by the tax filing deadline, including extensions. Given this change, individuals who converted in 2017 are the last group of taxpayers who are eligible to

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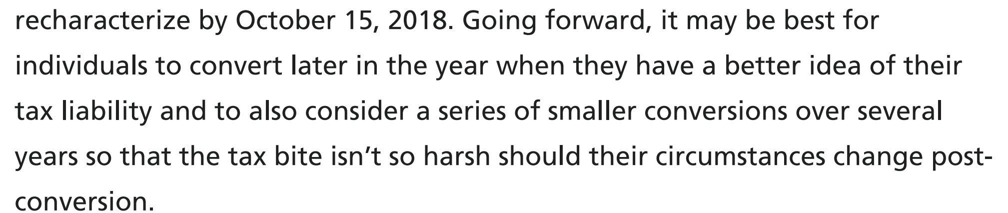

recharacterize by October 15, 2018. Going forward, it may be best for individuals to convert later in the year when they have a better idea of their tax liability and to also consider a series of smaller conversions over several years so that the tax bite isn't so harsh should their circumstances change post-conversion.

### *Plan Loan Offset Rules Modified:*

Individuals who terminate employment with an outstanding loan from their qualified plan must either restore the outstanding loan balance or replace the amount when rolling to another qualified plan or IRA to avoid being taxed on that amount. Prior to TCJA, the limit to do so was 60 days from the date of distribution. Effective 2018, plan loan offset amounts may be restored to another qualified plan or IRA by the employee's tax filing deadline plus extensions to avoid taxation (and potential 10% premature distribution tax) on the amount. This change was made permanent[17].

## BUSINESS RELATED REFORM

### *New "Qualified Business Income (QBI)" Deduction for Pass-Through Entities:*

One of the more talked about provisions of the legislation is a new deduction under IRC §199(A) for pass-through businesses; these include sole proprietors who file Schedule C, partnerships, LLCs and S corporations, all of which pass business income through to the individual's or partner's personal tax return. Effective January 1, 2018, a 20% deduction of QBI is permitted for these entities. It is important to note that QBI specifically excludes investment income, foreign business income, reasonable compensation to an S corporation owner-employee, nor does it include guaranteed payments for services in a partnership or LLC. The Act allows a 20% deduction against Qualified Business Income with some restrictions. The QBI deduction is further limited to the following criteria if certain thresholds of income are exceeded:

The *lesser* of:

1. 20% of qualified business income, or the greater of either:
   a. 50% of the W-2 wages paid, or
   b. 25% of W-2 wages plus 2.5% of the unadjusted basis after acquisition of qualified property.

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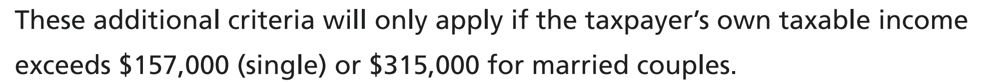

These additional criteria will only apply if the taxpayer's own taxable income exceeds $157,000 (single) or $315,000 for married couples.

However specified service businesses will be phased out completely from taking the QBI deduction once taxable income of the taxpayer exceeds $207,500 (individual) or $415,000 (married)[18]. In other words, they do not follow the second set of calculations described in 'a' and 'b' above but rather, the deduction simply phases out entirely at the $207,500 and $415,000 limits above. Specified service businesses are defined under IRC §1202(e)(3)(A) as any trade or business that relies on the reputation or skill of one or more of its employees. Examples include businesses in the fields of financial services, accounting, health, law, performing arts, consulting or athletics. With the complete phaseout of the QBI deduction for taxable income over the thresholds, it may be necessary for mid to large RIAs, for example, to consider changing to a C corporation or to at least opt to be taxed as one going forward.

## *New Flat Corporate Tax Rate/Repeal of Corporate AMT:*

Prior to TCJA, corporations were taxed using a four-tax rate system (15%, 25%, 34%, and 35%). Effective in 2018, the legislation reduces the tax rate for corporations to one flat tax rate of 21%[19]. The bill also permanently repealed the corporate AMT making corporations likely the big winners under the tax reform[20].

## *1031 Exchanges Limited to Real Estate:*

Prior to TCJA, 1031 exchanges were permissible between various types of investment properties such as classic cars and boats in additional to real property. TCJA limits 1031 exchanges to real property only after December 31, 2017[21].

## *Summary:*

The goal of a simplified tax system was accomplished in some respects yet, in others, leaves us analyzing the complexities of the new tax code to determine which strategies to employ to best help our clients. That will likely take months and perhaps even longer to uncover. Simpler or not, the new landscape of our tax code requires consumers to align themselves with tax and other qualified professionals to help them navigate the waters of this new legislation. At least through the expiration of the sunset period in 2025, most consumers will

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experience an increase in their spendable income. This leads to an opportunity for you to help them make the right choices. With some of the itemized deductions either eliminated or reduced, there is a need more than ever to discuss tax deferred and tax-free vehicles with your clients to help mitigate tax risk, particularly for those who may end up falling short compared to the pre-TCJA tax rules. Tax diversification is still a problem for many and it becomes even more of a potential issue as your clients approach retirement.

On the business side, I suspect that the biggest hurdle for pass-through business owners, at least in the foreseeable future, will be to analyze whether the new QBI deduction, and the restrictions that come along with it, will be enough to stay where they are or if switching to a corporation will be the way to go. Corporations undoubtedly fair well under the permanent flat rate system and the repeal of the AMT. Tax professionals will certainly have their work cut out for them. One thing is for sure. Change breeds opportunity and, as financial professionals, we need to seize it to empower our clients to make informed decisions based upon their unique situations.

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## *Sourcing:*

[i]Any reference comparing 2017 numbers to those under the new tax legislation may be found by referencing IRS Revenue Procedure 2016-55.

[1]H.R. 1, Subtitle A Part I, Section 11001

[2]H.R. 1, Subtitle A Part I, Section 11002

[3]H.R. 1, Subtitle A Part 1, Section 11001

[4]H.R. 1, Subtitle A Part III, Section 11021

[5]H.R. 1, Subtitle A Part V, Section 11041

[6]H.R. 1, Subtitle A Part III, Section 11022

[7]H.R. 1, Subtitle A Part V, Section 11042

[8]H.R. 1, Subtitle A Part V, Section 11043

[9]H.R. 1, Subtitle A Part V, Section 11045

[10]H.R. 1, Subtitle A Part V, 11048 and 11049

[11]H.R. 1, Subtitle A Part III, Section 11023

[12]H.R. 1, Subtitle A Part III, Section 11027

[13]H.R. 1, Subtitle A Part VIII, Section 11081

[14]H.R. 1, Subtitle A Part VI, Section 11061

[15]H.R. 1, Subtitle A Part IV, Section 11032

[16]H.R. 1, Subtitle C Part VII Subpart B, Section 13611

[17]H.R. 1, Subtitle C Part VII Subpart B, Section 13613

[18]H.R. 1, Subtitle A Part II, Section 11011

[19]H.R. 1, Subtitle C Part I, Section 13001

[20]H.R. 1, Subtitle B Section 12001

[21]H.R. 1, Subtitle C, Part IV, Section 13303

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