ADVISOR PERSPECTIVES

Highlights of the Final Tax Cuts and Jobs Act

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by Tim Steffen

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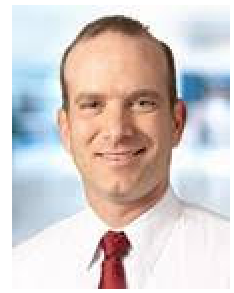

After weeks of comparing different tax reform proposals and debating how to best meet various goals, the Congressional Conference Committee released their combined version of the two Tax Cuts and Jobs Act proposals that were passed by the House and Senate. This version of the bill more closely resembles the Senate version, and includes tax rate cuts for individuals, corporations and pass-through businesses, an elimination of many forms of tax deductions, larger exemptions from the estate tax and Alternative Minimum Tax (AMT), and numerous changes affecting multi-national businesses.

While steps were made to simplify our federal tax system, this proposal seemed to fall short of where previous versions landed. For example, rather than repealing the estate tax and AMT, this proposal simply expands the exemptions. Fewer taxpayers will be affected by them, but with AMT specifically, many will still have to go through the calculations to be sure. Several of the exemptions and deductions that were repealed in the original versions found their way back into this latest version. And most importantly, most of the changes affecting individual taxpayers are scheduled to expire after 2025. While the expectation is that many of those will eventually be permanently extended, it does set us up for another fiscal cliff-like showdown, similar to what occurred at the end of 2012.

The next step for this proposal is for both the House and Senate to vote on whether or not to approve it. It appears that Republicans in both houses have enough votes to pass this without any Democratic support, and that is expected to happen in the next few days. From there it will go to President Trump who is expected to sign it into law.

The following are highlights of many of the provisions that will affect individuals and business owners. For a complete summary of all provisions in the bill, please visit http://docs.house.gov/billsthisweek/20171218/CRPT-115HRPT-466.pdf. Unless specifically stated, all provisions would take effect beginning in 2018.

Changes to individual tax rates and brackets

The combined proposal mostly adopts the Senate proposal by sticking with 7 tax brackets but changing the rates and the income levels to which they apply. One notable change is that the top rate would be lowered to 37% from 39.6%.

<table>
<tr><th>Married Filing Joint</th><th colspan="2">2018 Tax Rate</th></tr>
<tr><th>2018 Taxable Income</th><th>Current</th><th>Proposed</th></tr>
<tr><td>$0 – 19,050</td><td>10%</td><td>10%</td></tr>
<tr><td>$19,050 – 77,400</td><td>15%</td><td>12%</td></tr>
<tr><td>$77,400 – 156,150</td><td>25%</td><td rowspan="2">22%</td></tr>
<tr><td>$156,150 – 165,000</td><td rowspan="2">28%</td></tr>
<tr><td>$165,000 – 237,950</td><td rowspan="2">24%</td></tr>
<tr><td>$237,950 – 315,000</td><td rowspan="3">33%</td></tr>
<tr><td>$315,000 – 400,000</td><td>32%</td></tr>
<tr><td>$400,000 – 424,950</td><td rowspan="3">35%</td></tr>
<tr><td>$424,950 – 480,050</td><td>35%</td></tr>
<tr><td>$480,050 –600,000</td><td rowspan="2">39.6%</td></tr>
<tr><td>$600,000 +</td><td>37%</td></tr>
</table>

<table>
<tr><th>Single</th><th colspan="2">2018 Tax Rate</th></tr>
<tr><th>2018 Taxable Income</th><th>Current</th><th>Proposed</th></tr>
<tr><td>$0 – 9,525</td><td>10%</td><td>10%</td></tr>
<tr><td>$9,525 – 38,700</td><td>15%</td><td>12%</td></tr>
<tr><td>$38,700 – 82,500</td><td rowspan="2">25%</td><td>22%</td></tr>
<tr><td>$82,500 – 93,700</td><td rowspan="2">24%</td></tr>
<tr><td>$93,700 – 157,500</td><td rowspan="2">28%</td></tr>
<tr><td>$157,500 – 195,450</td><td rowspan="2">32%</td></tr>
<tr><td>$195,450 – 200,000</td><td rowspan="2">33%</td></tr>
<tr><td>$200,000 – 424,950</td><td rowspan="3">35%</td></tr>
<tr><td>$424,950 – 426,700</td><td>35%</td></tr>
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</table>

In general, marginal tax rates would fall at all levels. The exception would be income for couples between $400,000 and $424,950 (and singles between $200,000 and $424,950), where the marginal rate would increase from 33% to 35% in 2018. This proposal did not include the “bubble tax” that was part of the House bill, which would have eliminated the benefit of the lowest brackets for those at high income levels.

Also, because the brackets for married couples are almost always twice that of a single person, this marks a significant reduction of the marriage penalty. Two single individuals who make the same income would pay the same total tax individually as they would if they were married until their individual incomes reach $500,000. At that point, they would begin paying more tax as a married couple than as two single individuals. For 2017, that increase in tax begins once their individual incomes reach roughly $77,000.

These changes to the ordinary brackets require a corresponding change to the 2018 brackets for the three different capital gain rates:

Capital Gain Tax Rate	Long Term Capital Gain/ Qualified Dividend Income	
	Married Filing Joint	Single
0%	$0 – 77,200	$0 – 38,600
15%	$77,200 – 479,000	$38,600 -425,800
20%	$479,000 +	$425,800

All of these changes to ordinary and capital gain tax brackets and rates would expire after 2025 and revert back to the laws in effect for 2017.

Changes to deductions

This proposal would repeal the personal exemption, the $4,050 deduction allowed for each taxpayer and their dependents in 2017. The proposal would also increase the standard deduction, as shown in the table below.

Filing Status	2018 Standard Deduction, Current Law	2018 Standard Deduction, Proposed Law
Married Filing Joint	$13,000	$24,000
Married Filing Separate	$6,500	$12,000
Single	$6,500	$12,000
Head of Household	$9,550	$18,000

The elimination of the personal exemption and the increased standard deduction would be permanent changes. The House proposal would have eliminated the additional standard deduction for those over age 65 or who are blind. That was not included in this combined proposal, so those increases to the standard deduction would remain in place.

After much back and forth, the tax treatment of various deductible expenses would temporarily change as follows:

- The itemized deduction for **state and local taxes** would be capped at a total of $10,000. The limit would apply to the combined amount of income and property taxes paid during the year. However, any property or sales taxes paid in connection with a business (such as a sole proprietorship, rental property or farm) would remain fully deductible against income from that business. Property taxes paid on foreign real estate would no longer be deductible.

  - At one point this entire deduction was expected to be eliminated, but this $10,000 limit was a concession to taxpayers who live in high-tax states.
  - Taxpayers who anticipate owing some amount of state income tax when they file their 2017 tax return should consider paying that amount before the end of 2017. This can be done by either increasing withholding between now and year-end or making a separate payment to the state. However, taxpayers who are in (or are close to being in) the AMT wouldn't benefit from this pre-payment, so waiting to pay that balance due until the return is filed in April is likely the better option.
  - Some taxpayers have considered pre-paying their entire 2018 state tax liability before the end of 2017 in order to ensure a deduction. Some states will even issue a withholding exemption certificate that can be provided to their employer in those cases. However, this proposal contains a provision that would specifically deny a deduction for pre-paid state taxes in those situations.
- For mortgages entered into after December 15, 2017, the deduction for the interest paid would be limited to the first $750,000 of debt. Today, **interest on mortgage debt** up to $1 million is deductible, and those existing loans would be grandfathered under the current law. In addition, the deduction for interest paid on **home equity loans** – both new loans and existing – would be eliminated.

  - The deduction for interest paid for a second home would still be allowed under this new proposal, as long as the combined debt on the two homes doesn't exceed the applicable limit.
- This proposal would make two substantive changes to the deductibility of **charitable contributions**. Donations of cash to public charities would be deductible up to 60% of Adjusted Gross Income (AGI), rather than the current 50% limit. In addition, the charitable deduction for 80% of the amount paid to a college for the right to purchase athletic tickets would be repealed.
- The Senate and the House took opposite approaches to the deduction for **medical expenses**, with the House repealing it and the Senate expanding it. The compromise proposal took the Senate approach, and would make it easier to deduct these expenses. Effective for 2017 and 2018 only, medical expenses will be deductible as long as they exceed 7.5% of AGI. After 2018, the AGI floor will return to 10%. This is one of the very few proposed changes that would impact 2017.
- **Personal casualty losses** would no longer be deductible, other than those attributed to a disaster as declared by the President. Those losses would remain deductible subject to the current limitations.
- Expenses that fall under the category "**miscellaneous itemized deductions**" would no longer be deductible. These expenses are currently subject to the 2% of AGI floor, and include items such as tax preparation fees, investment-related expenses, hobby-related expenses (to the extent of hobby income), trustee fees (including fees paid for an IRA), safe deposit box rental, union dues, etc.
- The deduction for alimony paid to an ex-spouse would also be disallowed, and the income would no longer be taxable to the recipient. This would only apply to divorces entered into after 2018 (the original proposal applied after 2017), so existing agreements generally would not be impacted. However, if an existing agreement is modified after 2018, it would become subject to

this new rule.
- **Moving expenses** would no longer be deductible, other than for members of the armed forces who move due to a military order.
- Currently, losses from gambling can only be deducted to the extent of gambling winnings, while other expenses connected to gambling can be deducted in excess of winnings. This proposal would cap the deduction for both losses and other expenses to the amount of gambling winnings.

One concession made to high-income taxpayers has to do with the **phaseout of itemized deductions** (aka, the Pease limitation). In 2017, couples begin to lose the benefit of their itemized deductions once AGI exceeds $313,800 ($261,500 for singles). This phaseout would be repealed in 2018 under this proposal.

By limiting the deduction for income and property taxes and increasing the standard deduction, many taxpayers will switch from itemizing to taking the standard deduction. This will certainly simplify record keeping for many individuals, but it also removes an incentive to make annual gifts to charity. One strategy that may become more popular: the use of Donor Advised Funds, which can be funded with large gifts up front while delaying the actual distribution to a charity. Taxpayers may even want to create and fund these accounts before the end of 2017.

Unless otherwise stated, all of the above changes would expire after 2025, after which the treatment of these expenses would be reinstated to their 2017 status.

Mandate to purchase health insurance

This proposal adopts the Senate provision that would effectively eliminate the requirement for all individuals to be covered by a health plan that provides minimum essential coverage. Under the Affordable Care Act that was passed in 2010, individuals who don't purchase a policy meeting various requirements, and who aren't otherwise exempt from doing so, would pay a penalty equal to the greater of a specified dollar amount or a certain percentage of their income. Under this new proposal, the penalty for not purchasing insurance would be reduced to $0 in 2019 (one year later than most other provisions in this proposal), effectively ending the requirement. Insurance policies that are currently available through the various health care exchange programs would continue to be offered.

Enhanced child credit

This proposal would expand the existing child tax credit in the following ways:

- The credit would be expanded from $1,000 per qualifying child to $2,000.
- Children under age 17 at the end of the year would be eligible for the credit, matching current law. One of the earlier proposals would have extended this to age 18, but it did not make the final bill.
- There would be a new $500 credit for qualifying dependents not eligible for the $2,000 child credit.
- These credits would be phased out once income exceeds $400,000 for couples ($200,000 for all

other taxpayers), up from the current $110,000 and $55,000 levels (for couples and singles, respectively).

All of the changes to the child credit would expire after 2025 and revert back to the laws in effect for 2017.

Reduced taxes on pass-through business income

One of the other major themes of this tax reform debate has been a reduction in the taxes paid by businesses, and it was an area of significant difference between the two original proposals. The final bill ended up closer to the Senate version by exempting 20% of all net business taxable income earned by a partnership, S Corporation or sole proprietorship. This proposal makes no distinction between passive and active owners of a business, meaning both appear to benefit from this provision.

In order to help prevent abuse of this proposed exclusion, there are a variety of limitations imposed as explained below:

- The 20% exemption is capped at the greater of:
    - 50% of the amount of wages paid to employees and reported on a W-2.
    - 25% of those same wages plus 2.5% of the cost of depreciable property owned by the business.
- This W-2-related threshold would not apply to couples with taxable income below $315,000, and would only be phased in over their next $100,000 of income ($157,500 and $50,000 for all other taxpayers). Couples over $415,000 (and others over $217,500) would be fully subject to this W-2 limit.
- This exemption generally does not apply to specified service businesses, which include those in the fields of health, law, accounting, actuarial sciences, performing arts, consulting, financial services, brokerage services, or any other business where the primary asset is the reputation or skill of its employees. Engineering and architecture businesses were removed from this list in the combined bill.
    - As with the W-2 threshold, the exclusion for service corporations would not apply to couples with taxable income below $315,000, and would only be phased in over their next $100,000 of income ($157,500 and $50,000 for all other taxpayers). Couples over $415,000 (and others over $217,500) would be fully subject to this limitation on service corporations.
- The 20% exemption would apply to dividends from a real estate investment trust (REIT) and certain cooperatives, as well as income from a publicly traded partnership. These items would not be subject to the W-2 wages requirement.
- Losses realized by a business in one year would be treated as a loss in the following year for purposes of this exemption. In other words, a business couldn't generate a deductible loss in one year, but then have income the next year that benefits from the exemption. That income in year 2 must be offset by the loss in year 1 before calculating the 20% exemption.
- Any amount paid to an S Corporation owner that is treated as compensation (i.e., reported on a

W-2) would not be eligible for the exemption, nor would guaranteed payments paid to a partner in a partnership.

All of the changes to the taxation of pass-through business income would expire after 2025. At that point, pass-through business income would be again be taxed using the standard individual tax rates and brackets.

As a result of this change (and the new lower tax rate on C Corporations, discussed below), the decision on how to structure a business becomes much more complicated. Prior to this proposal, pass-through entities were generally viewed as the most tax-efficient structure. They would now have a top effective tax rate of 29.6% – still less than C Corporations. However, the limitations put on qualifying for the 20% exemption may have some pass-through businesses reconsider becoming a C Corporation.

One other change related to businesses other than corporations would limit the ability to deduct “excess business losses”. Under this rule, a couple could deduct a net loss from a business of up to $500,000 against their other income that year ($250,000 for other taxpayers). Any loss in excess of that limit would be considered a Net Operating Loss and would be carried forward to future tax years. This would only apply to losses incurred in 2018 through 2025.

IRA re-characterizations

The Senate proposal would permanently eliminate the ability to recharacterize a Roth conversion after it was completed. Currently taxpayers have until October 15 of the year after the year of conversion to essentially change their mind on doing the conversion. This technique allows taxpayers to undo conversions if the account has fallen in value, or even do large conversions up front and then reduce them later to an amount they’re willing to pay tax on. Under this proposal, once a Roth conversion is completed, the conversion amount cannot be changed. In other words, taxpayers must be willing to fully commit to the conversion once it’s completed.

As a result of this change, taxpayers who did a Roth conversion in 2017 and are considering a recharacterization should make their decision before the end of 2017. After December 31, they would lose that option forever.

This proposal does not prevent a recharacterization of a contribution to either a Traditional or Roth IRA (as had been in the original proposals), nor does it change the tax treatment of contributions to retirement plans (so called “Rothification”) or make any other changes to the rules for IRAs, Roth IRAs, etc. It also does not prevent the “backdoor Roth” contribution technique.

Changes to the kiddie tax

The current version of the kiddie tax requires any non-earned income over a threshold to be taxed as if it belonged to the child’s parent. Under this proposal, that income would be taxed using the proposed trust tax rates. Those rates are shown below:

Ordinary Taxable Income	Ordinary Income Tax Rate
$0 – 2,550	10%
$2,550 – 9,150	24%
$9,150 – 12,500	35%
$12,500 +	37%

Capital Gain Income	Capital Gain Tax Rate
$0 – 2,600	0%
$2,600 – 12,700	15%
$12,700 +	20%

Any earned income for the child would be taxed using the single tax brackets and rates. There would be no change in the definition of children subject to this tax. Under this proposal, the tax assessed on the child would not be affected by the income of their parents or their siblings, unlike today's law.

These revised kiddie tax rules would expire after 2025 and revert back to the law in effect for 2017.

Education incentives

The original proposal issued by the House would have modified or repealed several education-related tax incentives. The Senate version pared that list back quite a bit, and those are the items that survived in this bill. The proposed changes are:

- Section 529 plans would be able to distribute up to $10,000 per year to cover the cost of K-12 expenses while enrolled in a public, private or religious school. Today, the only tax-preferred way to save for those costs is by using a Coverdell Education Savings Account. No changes would be made to the rules regarding Coverdell accounts.
- The definition of qualified expenses for a 529 account would be expanded to include certain homeschooling expenses.
- If a student loan is discharged due to the death or permanent disability of the student, that discharge would no longer be considered taxable income.

The discharge of debt provision would expire after 2025, while the other two changes would be permanent.

Enhancements to ABLE accounts

ABLE accounts are a tax-preferred way for those with disabilities to save. Annual contributions are capped at the annual gift exclusion amount ($14,000 today) and are not deductible, but earnings in the account are tax-deferred, and can be tax-free if withdrawn for qualified disability expenses. This bill would allow ABLE beneficiaries to contribute their own earnings to the account once the $14,000 limitation is reached after gifts from others, subject to other limitations. These contributions by the beneficiary would also qualify for the saver's tax credit, and could be made as soon as this proposal is enacted.

In addition, a 529 account where a disabled individual is the beneficiary could be rolled into an ABLE account owned by that same individual. The rollover would count towards the annual contribution limit to the ABLE, however.

These changes would all expire after 2025 and revert back to the law in effect for 2017.

Estate tax changes

This proposal would double the estate exemption beginning in 2018. The exemption is currently scheduled to be $5.6 million, meaning it would become $11.2 million per person, or $22.4 million per couple. Those who had already used their estate exemption in prior years would be able to make additional tax-free gifts to non-spouse beneficiaries next year.

There would be no other changes to the gift, estate or generation skipping transfer taxes. The House plans to repeal the estate tax and lower the gift tax rate were not included in the proposal.

This increased estate tax exemption would expire after 2025 and revert back to the law in effect for 2017 with inflation adjustments.

Alternative minimum tax changes

Rather than repealing the Alternative Minimum Tax as the House had proposed, this bill follows the Senate version and would increase the exemption amounts, thereby reducing the number of taxpayers subject to AMT. Under the proposal, the AMT exemption for couples would increase from $78,750 in 2017 to $109,400 in 2018 (and from $50,600 to $70,300 for singles). The AGI level at which the exemption is phased out would also be increased, from $150,000 in 2017 to $1,000,000 in 2018 for couples (and from $112,500 to $500,000 for singles).

As a result, executives looking to exercise Incentive Stock Options should consider delaying those exercises until 2018. And those with AMT credit carryovers will find it much easier to recover those with these larger AMT exemption levels.

These increased exemptions and phaseout levels would expire after 2025 and would revert back to their 2017 levels, with inflation adjustments.

Business tax changes

While businesses structured as pass-through entities would be eligible for a new deduction of 20% of their income, those operating as C corporations would instead be subject to a new tax rate. These corporations, which pay their own tax rather than pass income through to their owners, would move from a tax rate of essentially 35% to a new flat rate of 21% for tax years beginning with 2018 (previous proposals had called for a 20% rate beginning in 2019).

This bill contains many other provisions affecting businesses, some of which are highlighted below:

- Businesses could **fully expense 100% of the cost of qualified property** placed in service after

September 27, 2017 and before 2023. The 100% would be reduced to 80% for 2023, 60% for 2024, 40% for 2025 and 20% for 2026, and then would reach 0% for 2027 and beyond. Currently businesses can immediately deduct 50% of that cost (with the 50% scheduled to gradually decrease and then expire in 2020), and then depreciate the balance of the cost over the asset's useful life.

- Businesses can currently expense up to $500,000 for the purchase of property considered **"Section 179" property**, as long as their total assets placed in service for the year don't exceed $2 million. This proposal would permanently increase the expense amount to $1 million and the phaseout threshold to $2.5 million, and then index both amounts for inflation. The proposal would also expand the definition of property eligible for the deduction. This is effective for property placed in service after 2017.
    - Between these two changes, large businesses may wish to delay the purchase of significant assets until after 2017 in order to take advantage of these increased deductions.
- **Like-kind exchanges** would only be allowed for real property (including rental properties), and not for personal property (such as vehicles or equipment).
- The **deduction for interest expense** would generally be limited to the sum of the business's interest income plus 30% of other taxable income, with some adjustments. Excess interest could be carried forward indefinitely. Businesses with average gross receipts of less than $25 million over the prior 3 years would be exempt from this limitation.
- The carryback of **Net Operating Losses** would essentially be repealed (with some exceptions for farmers and insurance companies), but those losses could instead be carried forward indefinitely (versus for just 20 years today). Only 80% of current income could be offset with an NOL carryforward, with the remainder of the NOL continuing to carry forward.
- The **corporate AMT** would be permanently repealed.
- Businesses could no longer deduct the cost of **entertainment or recreation activities**, or **membership dues** relating to those activities, as well as **on-premises gyms or other amenities** for employees that are primarily personal in nature.
- Beginning in 2019, **employers could claim a tax credit** equal to 12.5% of the wages paid to an employee on family and medical leave (FMLA), as long as they're paid at least 50% of their normal wage. The credit rate would increase as the FMLA payment increased above 50% of normal wages.

Employer-provided fringe benefits

Employers are currently able to provide a variety of fringe benefits to their employees without the employee having to report them as taxable income. This proposal would repeal the exclusions for employer-reimbursed moving expenses and bicycle commuting expenses. Both of these items would expire after 2025, making these reimbursements tax-free again in 2026.

Miscellaneous provisions

A variety of other changes were included in this proposal, including the following:

- **Tax-exempt organizations** would be subject to a 21% tax on compensation over $1 million paid to their five highest paid employees for the year.
- **Private colleges and universities** with at least 500 tuition-paying students would be subject to a 1.4% tax on their net investment income if their assets not directly used for educational purposes exceeds $500,000 per student.
- The new proposal would extend the time in which an employee can pay back a **loan from their 401(k) plan** and avoid an "offset", but only if the offset is due to leaving the employer or the employer terminating the plan.
- Certain **employees of privately held companies** who receive stock options or restricted stock units as compensation would be able to exercise those and then defer the recognition of income for up to five years.

Earlier proposals not in the final bill

Among the changes that were previously considered by either the House or Senate, but were not included in the final bill, are the following:

- The change that would have required taxpayers to determine the cost basis of any security sold after December 31, 2017 on a first-in, first-out basis, otherwise known as the **FIFO rule**, was removed. Investors can continue to specifically identify a tax lot to sell when multiple lots (with different cost basis and holding periods) of a position are owned.
- No changes would be made to the rules regarding excluding the gain from the **sale of a personal residence**.
- The **deduction allowed for educators** who provide supplies and other materials for their classroom would remain $250, rather than increase to $500.
- The proposed Family Credit of $300 per person not eligible for the enhanced Child Credit was not included.
- Regarding education-related provisions:
    - The Hope Scholarship Credit and the Lifetime Learning Credit would remain, and the American Opportunity Credit would remain only available for the student's first four years of college.
    - Interest on student loans would continue to be deductible.
    - Free tuition and cash provided to employees of colleges (and their spouses and children), such as graduate students, would remain tax free.
    - Interest on US savings bonds would remain tax-free up to the amount of qualified college expenses.
    - Employer would still be able to provide up to $5,250 of educational assistant to employees tax-free.
- In addition to education assistance, the following other employer fringe benefits would continue to be tax-free for employees: Housing provided to an employee for the convenience of the employer, Qualified adoption expenses paid for or reimbursed by the employer, and employee achievement

awards.

- Tax-deductible contributions to Archer Medical Savings Accounts and Dependent Care Flexible Savings Accounts would continue to be allowed.
- The cost of nonresidential real property and residential rental property would continue to be deducted over 39 and 27.5 years, respectively, rather than change to 25 years.
- Interest from newly-issued private activity bonds would remain exempt from federal income tax, although it would continue to be taxable for the AMT.
- The excise tax charged on the income of private foundations would remain at 2%, with some foundations continuing to qualify for a 1% tax.
- The proposal to allow unborn children to named beneficiaries of a 529 plan was not included.

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