# THE TAX CUTS AND JOBS ACT

New tax legislation - The Tax Cuts and Jobs Act (the “Act”) - was signed into law by President Trump on December 22, 2017.

The Act makes almost all changes to individual income tax provisions temporary – nearly all expire at the end of 2025. Most corporate provisions are permanent.

What follows is a highly condensed summary of the Act.

## INDIVIDUAL TAXES

| | 2017 Law | New Legislation |
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| **Individual Tax Rates** | 10, 15, 25, 28, 33, 35, 39.6% | 10, 12, 22, 24, 32, 35, 37%<br>Top rate would apply to income over $600,000 for married filing jointly; $500,000 for single |
| **Standard Deduction** | $12,700 ($6,350 if single) | $24,000 ($12,000 if single), enhanced for elderly and blind |
| **Kiddie Tax** | Unearned income of a child taxed at parents’ tax rate if higher than child’s rate | Simplifies kiddie tax by applying trust rates to unearned income of a child |
| **Personal Exemption** | $4,050 subject to phase-out | Eliminates: merged with higher standard deduction |
| **Child/Dependent Tax Credits** | $1,000, per qualifying child subject to phase-out beginning at $110,000 | $2,000 per qualifying child $500 per non-child dependent; subject to |

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| | (married) and $75,000 (single taxpayers) | phase-out beginning at $400,000 (married) and $200,000 others |
| **Top Capital Gains/Dividend Tax Rate** | 20% (plus 3.8% surtax) | Current maximum rate is retained; same breakpoints as current law |
| **Itemized Deductions** | Under the “Pease” limitation up to 80% of most itemized deductions are lost when adjusted gross income exceeds $313,800 ($261,500 for single taxpayers) | Repeals the Pease limitation in itemized deductions.<br>Mortgage interest deduction: $750,000 limit on acquisition indebtedness retained (principal or secondary residence); deduction for home equity loan repealed.<br>Deduction for state and local income, sales tax and real property taxes limited to $10,000 in aggregate ($5,000 for married filing separately); deduction allowed for state and local taxes on trade or business or if related to production of income. Payment of income taxes in 2017 for a subsequent year would not be deductible in 2017. No comparable rule for real estate taxes. |

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| | | Deduction for medical expenses retained and liberalized for 2017 and 2018 |
| **Retirement Savings** | Contributions can be placed into deferred account, up to contribution cap | Unchanged |
| **AMT** | Parallel tax calculation with to rate of 28% and $84,500 exemption for married taxpayers ($54,300 others); phase out of exemption begins at $160,900 for married taxpayers ($120,700 others) | Retains and modifies AMT; exemptions raised to $109,4000 (married) and $70,300 (others); phase-out of exemption begins at $1 million for married taxpayers ($500,000 others)[4] |
| **Carried interest** | Retains character as capital gain and eligible for preferential tax rates | Requires three-year period to attain long-term capital gains rate |
| **Investment Surtax** | 3.8% tax on “net investment income” | Unchanged – continues to apply. |

There will be winners and losers on the personal income tax side. Generally, wage earners from no-tax states could see tax savings under the Act (there are nine states that impose no state income tax: AK, FL, NH, NV, SD, TN, TX, WA and WY-NH and TN impose a tax only on dividends and interest).

Very high-wage earners from high-tax states could see a higher tax bill.

An Illinois married couple earning $300,000, with $10,000 in Illinois taxes, $10,000 in real estate taxes, $10,000 in mortgage interest, and $10,000 in charitable contributions would see a reduction of about $6,000 in Federal tax.

If this Illinois taxpayer was single, the tax savings would be $400.

It appears that state of residence (high tax vs. no tax state), type of income (wages versus new "qualified business income"), and mortgage interest will be among the most important factors for determining whether one is better or worse off under the Act.

**ESTATE AND GIFT TRANSFER TAXES**

| | **2017 Law** | **New Legislation** |
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| **Estate/Gift/GST Tax** | 40% Rate, $5,600,000 exemption (indexed for inflation) | Commencing 2018, exemption for Estate, Gift and GST tax doubled from $5.6 million to 11.2 million (indexed for inflation) Enhanced exemption expires end of 2025 |
| **Tax Basis Upon Death** | Step-up for estate property | Same as current; step-up for estate property |

There is a temporary doubling of the exemptions until the end of 2025, reverting back to 2017 law in 2026.  The step-up in basis at death would continue the entire time.  The high exemption amounts ($11.2 million for individuals and $22.4 million for a married couple in 2018) would effectively eliminate the tax for most people. This change would have a significant effect on both post-death and pre-death estate planning.

<u>Post-Death (Testamentary) planning</u>. It is common for wills and revocable trusts to contain dispositions which reference the estate exemptions that are in effect at death. These so-called "formula" provisions would automatically adjust for changes in the exemption amounts. While this may achieve a beneficial tax result, the temporary doubling of the exemptions may also cause unintended consequences to the dispositive plan. For example, a common plan is to leave the estate exemption to a bypass (a/k/a family) trust, and the balance for the surviving spouse, either outright or in a marital trust. For a hypothetical $11 million estate, if death had occurred in 2017, approximately half would go to the bypass/family trust and half to the spouse. However, if death occurs in 2018 to 2025, that would result in the entire estate being left to the bypass/family trust and none to the spouse. Further complications could arise for individuals living in certain states which impose estate tax, such as Illinois. Estate documents should be reviewed to make certain they accurately reflect the wishes of the parties. Ideally documents should be drafted with flexible provisions that can be adjusted for future changes.

<u>Pre-Death (Lifetime) planning</u>. Lifetime gifts are often made in order to reduce the estate tax that would otherwise be incurred at death. While doubling of the exemptions may seem to avoid the need for lifetime gifting for certain individuals, this would only be the case if death occurs before 2026. Accordingly, the tax consequences of making a

current gift may have to be compared with alternative estate tax scenarios. The temporary nature of the increase in transfer tax exemptions also raises the issue of whether it is advisable to lock-in the higher exemption by making a lifetime gift before 2026. This raises the question of whether there would be recapture (a/k/a "claw-back") if a lower exemption is in effect at death. In sum, the uncertainty of the estate exemption amount at death will make lifetime planning more challenging.

## CORPORATE TAXES

| | **2017 Law** | **New Legislation** |
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| **Top C-Corporate Rate** | 35% | 21% effective 2018 |
| **AMT** | Parallel tax calculation with top rate of 20% | Eliminates AMT |
| **Business Investments** | Limited immediate expensing; balance subject to depreciation | Immediate expensing for new and used qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023 (Jan. 1, 2024 for certain property) and partial expensing for other property acquired after 2022 and before 2027. |
| **Interest Expense** | No limitation | Limited to business interest income (EBITDA for 2017-2021 and EBIT thereafter); with special rules for "floor plan |

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| | | financing indebtedness”; full deduction for small businesses with gross receipts of $25 million or less |

**PASS-THOROUGH ENTITY TAXES**

| | 2017 Law | New Legislation |
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| **Top Rate: Pass-Through Entities (S-corporations, LLCs, LLPs and Partnerships) / Sole Proprietorships** | Subject to tax at individual rates up to 39.6% | An individual taxpayer generally may deduct 20% of domestic qualified business income from a partnership, S corporation, or sole proprietorship.<br>In the case of a taxpayer who has qualified business income from a partnership, S corporation or sole proprietorship, the amount of the deduction is limited to the greater of (i) 50% of the W-2 wages paid by the business or (ii) sum of 25% of W-2 wages paid by business and 2.5% of business capital. This wage limitation (i) does not apply if taxpayer’s taxable income is less than |

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| | | \$157,000 (\$315,000 for joint return; (ii) applies fully if taxable income exceeds \$207,000 (\$415,000 for joint return); and (iii) applies proportionately if taxable income is between those two limits.<br>Trusts and estates that own business interests qualify for this deduction<br>Deduction is a post-AGI item, even for taxpayers not itemizing deductions |
| **Pass-Through Entities – Service Businesses** | Subject to tax at individual rates up to 39.6% | For “specified service business” (i) the 20% deduction applies fully if taxpayer’s taxable income is less than \$157,500 (\$315,000 for joint return); (ii) there is no deduction if taxable income exceeds \$207,000 (\$415,000 for joint return); and (ii) there is a partial deduction if taxable income is between those two limits.<br>Service business includes accounting, law, consulting, investing, etc., |

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| | | but excludes engineering and architecture services |

Both Houses of Congress took fundamentally different approaches to the taxation of pass-through entities (sole proprietorships, partnerships, LLCs, LLPs and S-corporations). While they differed, they shared the goal of creating preferential treatment for certain pass-through business income. The Act approaches small business relief by permitting a non-itemized deduction of 20% of qualified business income; the reduced amount would then be subject to normal tax rates. Therefore, the top tax rate for business income would be 29.6% (100% - 20% = 80%) x 37% = 29.6%). The provision is riddled with a host of complex limitations. For taxpayers not in the top income tax bracket, the value of the deduction will depend on the marginal bracket that would otherwise be imposed on the income.

Owners of service businesses (e.g., law, accounting and consulting, etc., but not engineering or architectural services) generally would be eligible for the 20% deduction unless taxable income exceeds $315,000 for married filing jointly ($157,000 for others). The benefit of 20% deduction is phased out and fully eliminated out over the next $100,000 of taxable income for married filing jointly ($50,000 for others).

While upper-income wage earners in high-tax states generally do not fare well under the Act, taxpayers with substantial income from pass-through businesses should see a tax benefit compared with current law, since the weighted average rate of business income would be approximately 30%. Capital gains, dividends, and other preferential income from a business would not be considered “business income” and would continue to be taxed at preferential tax rates.

## OTHER PROVISIONS

The Act has other provisions of note.

- **Roth recharacterization no longer allowed.** Under 2017 law, if you converted a traditional IRA to a Roth IRA, you could “re-characterize” that conversion within certain time limits, in effect undoing it. For tax years beginning after 2017, the Act repeals this rule, meaning you can no longer re-characterize a Roth conversion.
- **Taxation of Alimony.** Under 2017 law, alimony and separate maintenance payments are deductible by the payer and includible in income by the recipient. (Child support payments are not treated as alimony.) The Act reverses this treatment, making alimony and separate maintenance payments non-deductible to the payer and non-taxable to the recipient but delays the effective date by one year, generally being effective for any divorce or separation instrument executed after December 31, 2018.
- **Sale of principal residence exclusion.** Under 2017 law, up to $250,000 of gain ($500,000 if filing jointly) on the sale of principal residence can be excluded from income. Among the requirements is that the principal residence be owned and used as your principal residence for two out of the last five years. You can use this rule only once every two years. This exemption is available regardless of income. Both the House and Senate Bills proposed changing these rules to five out of the last eight years and only once every five years. Interestingly, none of these

modifications were included in the Act. As a result, no changes are made to the principal residence exclusion rules.

- **Identification of Securities Sold, Exchanged and Gifted.** Under 2017 law, gain or loss generally is recognized for Federal income tax purposes on the sale of property. A taxpayer's gain or loss on a disposition of property is the difference between the amount realized on the sale and the taxpayer's cost basis in the property. If a taxpayer has acquired stock in a corporation on different dates or at different prices and sells or transfers some of the shares of that stock, and the lot from which the stock is sold or transferred is not adequately identified, the shares sold are deemed to be from the earliest acquired shares (the "first-in-first-out rule; FIFO). However, if a taxpayer specifically identifies the shares of stock to be sold, the shares of stock treated as sold are the shares that have been identified. The same rules apply to charitable gifts and gifts to trusts or family members. Although the Senate bill had proposed mandating that the FIFO rule be used, the Act makes no changes; the current rules will remain in place.
- **Like-kind exchanges.** Under 2017 law, real estate and personal property can qualify for a tax-deferred like-kind exchange. The property must be held either for investment or for use in a trade or business. Under the Act, like-kind exchanges will be available only for real estate, not personal property. This new rule is effective for transfers after 2017.
- **529 Savings Plans.** Under 2017 law, funds in 529 Saving Plans can be withdrawn tax-free if used for higher education expenses. The Act expands the type of expense that can be paid via a 529 Savings Plan and allows up to $10,000 per year

to be used for elementary and high school tuition and specifically allows funds to be used for private and religious schools. A provision that would have also allowed funds to be used for home schooling was dropped at the last minute and is not in the final legislation.

- **Charitable Gifts.** A charitable contribution deduction is currently limited to a certain percentage of the individual's adjusted gross income (AGI), and this limitation varies depending on the type of property contributed and the type of exempt organization receiving the property. Under 2017 law, cash contributed to public charities, private operating foundations, and certain non-operating private foundations generally may be deducted up to 50% of the donor's AGI. Under the Act, this 50% limitation is increased to 60%. The provision would retain the 5-year carryover period to the extent that the contribution amount exceeds 60% of the donor's AGI.
- **Investment Expenses and Investment Interest.** Under 2017 law, investment expenses are deductible as a "miscellaneous itemized deduction" if, and to the extent, they exceed 2% of AGI. The Act repeals the deduction for ""miscellaneous itemized deduction" that are subject to the 2% AGI limitation, such as investment management expenses. Under 2017 law, investment interest is not a "miscellaneous itemized deduction." Therefore, the deduction for investment interest remains untouched and, as under current law, would be limited to investment income.

## CONCLUSION

The Tax Cuts and Jobs Act is the first major tax overhaul in 30+ years. As a result, we probably need to understand that it's as far from tax simplification as one can get. Our office has been monitoring this legislation for months and has been immersed in interpreting the Act. There will be a significant amount of Treasury Regulations that will need to be issued to clarify many aspects of the bill. Who knows when we will have further guidance?

In the interim, visit our website for any updates or tax tips (www.messina-cpa.com).

For our clients in which we are preparing their 2017 tax return, we will be calculating the financial impact of the Tax Cuts and Jobs Act.

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