# Examining the Tax Cuts and Jobs Act

## Sweeping tax law changes

In the final weeks of 2017, Congress passed the most comprehensive tax reform package in decades, reducing tax rates for individuals and corporations and making modifications to many tax rules including deductions. The bill represented the largest change to the tax code since President Reagan's Tax Reform Act of 1986.

President Trump signed the "Tax Cuts and Jobs Act" (TCJA) into law on December 22, 2017. The broad changes to tax law impact individuals, estates, trusts, corporations, and small businesses. While lawmakers initially sought to simplify the tax code, the final package was mixed. Some provisions have been eliminated or simplified, while several new tax rules were added.

Under the new law, federal taxes for individuals would decline, on average, by 8%. The average tax rate would fall to 19% from 20.7%, according to the Joint Committee on Taxation. The net cost of the law is also projected to reach $1.4 trillion over the next 10 years.

Because Republicans in Congress chose to work within the budgetary rules of "reconciliation" to ensure passage with a simple majority in the Senate, the provisions for individual taxpayers generally will sunset after 2025. This means that individual and estate tax cuts, as well as the increases in the standard deduction, child tax credit, and other individual provisions, will expire. The potential for tax rates to increase at that time creates a challenge for financial planning, unless Congress takes action before the provisions sunset.

## Individual tax provisions

### Tax rates lowered

The law maintains the current structure of seven tax brackets but lowers the marginal rates in most of the brackets. While there was discussion of repeal, the 3.8% Medicare surtax on net investment income still applies for individuals, married couples, and trusts at higher income levels.

- The new highest rate of 37% (versus 39.6%) applies to over $500,000 of taxable income for individuals and $600,000 for married couples (based on 2018 tax brackets)
- New tax brackets are 10%, 12%, 22%, 24%, 32%, 35%, and 37%

## Comparing the new rates with the old

### Individuals

| Taxable income | Previous tax rate | TCJA tax rate | Change |
|---|---|---|---|
| $0–$9,525 | 10% | 10% | *Unchanged* |
| $9,526–$38,700 | 15% | 12% | –3.0% |
| $38,701–$82,500 | 25% | 22% | –3.0% |
| $82,501–$93,700 | 25% | 24% | –1.0% |
| $93,701–$157,500 | 28% | 24% | –4.0% |
| $157,501–$195,450 | 28% | 32% | +4.0% |
| $195,451–$200,000 | 33% | 32% | –1.0% |
| $200,001–$424,950 | 33% | 35% | +2.0% |
| $424,951–$426,700 | 35% | 35% | *Unchanged* |
| $426,701–$500,000 | 39.6% | 35% | –4.6% |
| Over $500,000 | 39.6% | 37% | –2.6% |

Chart reflects tax rates on specific increments of income based on 2018 marginal tax brackets. The data does not include the 3.8% Medicare surtax on net investment income that applies to individuals with a modified adjusted gross income of over $200,000.

### Married filing jointly

| Taxable income | Previous tax rate | TCJA tax rate | Change |
|---|---|---|---|
| \$0–\$19,050 | 10% | 10% | *Unchanged* |
| \$19,051–\$77,400 | 15% | 12% | –3.0% |
| \$77,401–\$156,150 | 25% | 22% | –3.0% |
| \$156,151–\$165,000 | 28% | 22% | –6.0% |
| \$165,001–\$237,950 | 28% | 24% | –4.0% |
| \$237,951–\$315,000 | 33% | 24% | –9.0% |
| \$315,001–\$400,000 | 33% | 32% | –1.0% |
| \$400,001–\$424,950 | 33% | 35% | +2.0% |
| \$424,951–\$480,050 | 35% | 35% | *Unchanged* |
| \$480,051–\$600,000 | 39.6% | 35% | –4.6% |
| Over \$600,000 | 39.6% | 37% | –2.6% |

Chart reflects tax rates on specific increments of income based on 2018 marginal tax brackets. The data does not include the 3.8% Medicare surtax on net investment income that applies to couples with a modified adjusted gross income of over \$250,000.

### Capital gains and qualified dividend tax rates unchanged

The new law does not change the tax rates for capital gains and qualified dividend income. However, tax rates on qualified dividends and long-term capital gains are not specifically aligned by a marginal income tax bracket, but instead by income thresholds. Previously, taxpayers in the 10% and 15% marginal income tax brackets were subject to zero tax, those in the 25%/28%/33%/35% brackets were subject to a 15% tax rate, and taxpayers in the highest bracket of 39.6% were subject to a 20% tax rate.

| Individuals | Married/filing jointly | Tax rate |
|---|---|---|
| \$0–\$38,600 | \$0–\$77,200 | 0% |
| \$38,601–\$425,800 | \$77,201–\$479,000 | 15% |
| Over \$425,800 | Over \$479,000 | 20% |

Income thresholds are based on 2018 tax figures. Does not include the 3.8% Medicare surtax on net investment income that applies to single taxpayers with a modified gross income over \$200,000 (\$250,000 for couples).

## Key changes to deductions

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| **Standard deduction** | Nearly doubled to \$12,000 for individuals and \$24,000 for married couples; elderly or blind still receive an additional deduction of \$1,300 for married taxpayers (for each spouse meeting the applicable criterion). The additional amount for single individuals is \$1,600. (Note that, for 2023, the standard deduction is now \$13,850 for individuals and \$27,700 for married couples) |
| **Mortgage interest** | Deduction of interest on up to \$750,000 of aggregate mortgage debt used to build, acquire, or improve a property (including interest on a HELOC). Grandfather provision applies to debt acquired prior to December 15, 2017; allows interest on up to \$1 million to be deducted |
| **State and local taxes** | Capped at an aggregate total of \$10,000 (state/local income or sales taxes, local property taxes) |
| **Medical expenses** | Expanded by reducing threshold of when taxpayers can begin deducting expenses to 7.5% of adjusted gross income (AGI) (from 10% previously) |
| **Charitable deduction** | Maximum annual contribution (applied for donating cash to a public charity) increased from 50% of adjusted gross income (AGI) to 60% of AGI |
| **Miscellaneous 2% deductions** | Eliminated. Some examples include unreimbursed employment expenses, union or professional dues, investment fees, and tax preparation fees |
| **Moving expenses** | Eliminated, except for members of the armed services |

### Significant changes to deductions and exemptions

In order to provide revenue to offset the decrease in marginal rates, many popular deductions were either eliminated or scaled back *(see table on previous page)*. The law provides for a near doubling of the existing standard deduction for individuals and married couples, while the personal exemption has been repealed.

In fact, with the higher standard deduction, it is estimated that less than 10% of taxpayers will itemize deductions on their tax return going forward, down from about 30% that itemize today.

### Child tax credit (CTC) expanded

While the loss of personal exemptions will impact families with children, many will benefit from an expanded child tax credit. A significant increase in the income threshold triggering a phaseout will allow more individuals and married couples to take advantage of the credit.

The higher CTC, however, like other individual tax provisions, will expire after 2025.

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| **Amount of the tax credit** | Increased to $2,000 (from $1,000) for "qualifying children" (generally under age 17 at the end of the year). Additional $500 tax credit applies to other dependents who are not qualifying children (e.g., dependent children age 17 and older) |
| **Income phaseout** | Increased significantly to $200,000 for individuals and $400,000 for married/filing jointly (from $75,000 and $110,000, respectively) |

Consider the following example, which illustrates the combined effects of a higher standard deduction, the elimination of personal exemptions, an expanded CTC, and lower brackets.

### Loss of personal exemption versus expanded CTC and higher standard deduction

- Family of four with two children under age 17
- 28% marginal tax bracket under previous tax system; 24% TCJA tax bracket
- Claiming standard deduction

| | Previous system | TCJA |
|---|---|---|
| Adjusted gross income | $200,000 | $200,000 |
| Standard deduction | –$13,000 | –$24,000 |
| Personal exemptions | –$16,600 | $0 |
| Taxable income | $170,400 | $176,000 |
| **Taxes owed** | **$34,335** | **$30,819** |
| Child tax credit | $0 | –$4,000 |
| **Net taxes** | **$34,335** | **$26,819** |

Calculation is based on comparison of 2017 to 2018 tax rates.

### The individual alternative minimum tax (AMT) remains, with modifications

The combined effect of increasing the AMT exemption amount and the income phaseout before the exemption amount is reduced or eliminated entirely will result in fewer AMT taxpayers. In fact, according to the Tax Policy Center, the total number of AMT taxpayers is projected to decrease from roughly 5 million each year to 200,000. The AMT exemption amount is the amount that a taxpayer is allowed to deduct from alternative minimum taxable income before calculating the taxpayer's AMT liability.

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| **Higher AMT exemption amount** | $70,300 for individuals (from $55,400) and $109,400 if married/filing jointly or a surviving spouse (from $86,200) |
| **The phaseout for the AMT exemption increased** | Increased to $500,000 of AMT income for individuals and $1,000,000 if married/filing jointly or a surviving spouse (previous figures were $123,100 for individuals and $164,100 if married/filing jointly or a surviving spouse) |

Figures referenced represent 2018 tax figures.

### Other key areas affecting individual taxpayers

- Beginning in 2018, annual inflation adjustments are based on a formula that generally results in a lower inflation figure ("chained" CPI versus standard CPI) in certain cases.
- The option to recharacterize, or "undo," a Roth IRA conversion is eliminated.
- While lawmakers discussed the idea of requiring stock sellers to use the first-in, first-out (FIFO) method for calculating cost basis, this provision was not included in the final version.
- For itemized deductions that remain, there are no phaseouts at higher income levels (that is, the "Pease" rule is repealed).
- 529 college savings plans are expanded — account owners can utilize up to $10,000 annually to cover K–12 tuition.
- Alimony payments are no longer deductible, and alimony received is not considered taxable income (effective January 1, 2019; divorces finalized before 2019 are grandfathered).

## Estate and gift tax provisions

### New rules lessen the estate tax burden

While the original House bill called for the repeal of the estate tax, the final legislation retains the tax with modifications. The unified, lifetime exclusion for estates and gifts is nearly doubled, which will significantly reduce the number of taxable estates.

Under the new rules, less than 2,000 estates would be taxable, according to the Joint Committee on Taxation. Under the 2017 exemption amounts, about 5,000 estates would have owed estate taxes.

## Estate and gifts*

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| **Lifetime exclusion amount** | Doubled to $11.18 million for estates, gifts, and generation-skipping tax transfers (GST) |

* Maximum estate and gift tax rate remains 40%, and the annual gift exclusion is $15,000.

Married couples with less than $22 million in net worth will generally escape the federal estate tax.

For 2023, the lifetime exclusion is $12.92 million per individual.

However, even though estate and gift taxes may not apply, investors still need to address other important areas of estate planning including key documents such as wills, powers of attorney, strategies to avoid probate, and, depending on residency, planning for estate taxes at the state level. Twelve states and the District of Columbia have an estate tax (though many of those states have exclusion amounts tagged to the federal level), and six states have an inheritance tax. Maryland has both.

## Business-related provisions

### Overhaul of corporate tax code

Corporate taxation changes dramatically as tax rates are lowered — from a maximum of 35% to a flat rate of 21%, as well as by transitioning from a "worldwide" system of taxation to a mostly "territorial" system. The territorial system means that, generally, only corporate earnings in the United States will be subject to tax, as opposed to earnings worldwide.

Proponents of the measure note that the new structure better aligns the United States with most developed nations.

## Highlights of provisions affecting corporations

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| **Enhanced expensing for capital expenditures** | Corporations can apply 100% expensing on capital expenditures (with some exclusions, such as property used in a real property trade or business) over the next five years, with a gradual phaseout afterward.* There are also enhanced expensing rules for small businesses† |
| **Lower deduction for interest payments** | Deduction for net interest payments on debt allocable to a trade or business is generally limited to a maximum of 30% of adjusted taxable income, subject to certain exceptions and exclusions |
| **Overseas profits are "deemed" to be repatriated** | Profits held overseas are repatriated at a tax rate of 15.5% for cash and 8% for non-liquid assets |

* New expensing guidelines apply to qualified property purchased after September 27, 2017.

† For property placed in service in tax years beginning after December 31, 2017, the maximum amount a taxpayer may expense under Code Sec. 179 is increased from $500,000 to $1 million.

### New tax rules for small businesses operating as pass-through entities

- Most businesses in the United States are not large corporations, but are structured as "pass through" entities such as S corps, LLCs, partnerships, and sole proprietorships. While the marginal tax rates for individuals and married couples apply (with a maximum of 37%), many of these businesses will benefit from a new 20% deduction of qualified business income (QBI).
- Specific service businesses, such as health, law, and professional services, may be limited in claiming this deduction, depending on their income.
- A late change in the legislation removed engineering and architecture professions from being considered "specified service businesses."

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| **Taxable income of $157,000 (individuals) or $315,000 (married/ filing jointly) or less** | 20% deduction available (including service businesses) |
| **Over $157,500 but under $207,500 (individuals) or over $315,000 but under $415,000 (married/ filing jointly)** | 20% deduction available to non-service businesses subject to a wage limitation;‡ deduction begins to be phased out for service businesses |
| **At least $207,500 (individuals) or $415,000 (married/ filing jointly)** | No deduction for specified service business. Other businesses can qualify for a deduction equal to 20% of qualified business income‡ |

‡ The deduction may be subject to a wage limitation based on total wages paid or a combination of wages paid and unadjusted basis of property held by the business.

These figures are 2018 tax figures and do not reflect inflation adjustments for 2023 tax year.

## Planning considerations

### Individuals

**Municipal bonds still attractive for many investors.** Even with marginal rates decreasing, many high-income taxpayers may find municipal bonds attractive as a source of tax-free income, particularly as the 3.8% surtax on net investment income still applies.

**Understanding tax brackets will drive strategies.** Taxpayers will want to assess the impact of the new rates and brackets on their personal situation. This will help drive decisions around tactical timing of income, losses, and deductions, as well as other strategies such as Roth IRA conversions.

**Assess new rules on mortgage interest deductions.** Homeowners should be aware of the new rules limiting the mortgage deduction as well as the potential loss of the tax benefit on HELOCs as a liquidity option.

**Consider timing strategies for charitable donations.** Taxpayers — especially those who are committed to regular charitable donations — may see the appeal of "lumping" deductions into one year and itemizing deductions on the tax return for that particular year. For example, instead of making consistent charitable gifts each year, consider making a large gift in one year or funding a donor-advised fund if that allows you to itemize deductions on your tax return. In other years, claim the expanded standard deduction.

**Residents in high-property tax states may benefit from relocation.** Those living in high income and property tax states may consider a change in domicile, especially if they own another home in a state with lower taxes.

**Donate to charities using the Charitable IRA rollover provision.** IRA owners (age 70½ and older) may benefit from directing charitable gifts of up to $100,000 from their IRA and claiming the higher standard deduction.

**More flexibility for 529 college savings plans.** Families planning for education should consider expanding use of their 529 plans since funds (up to $10,000 annually) can be utilized for K–12 tuition expenses.

**Carefully assess Roth IRA conversions.** Roth IRA conversions need to be closely analyzed since the recharacterization provision, which allowed investors to reverse a conversion, is no longer available.

### Estate planning

**Estate planning remains critical.** While estate and gift taxes may be less of a concern for most families, careful planning is still needed to transfer wealth efficiently. This includes avoiding probate; contingency planning with documents such as wills, powers of attorney, and health care proxies; and updating beneficiary designations regularly.

**Be mindful of state estate taxes.** Address potential state estate or inheritance taxes. Even though fewer estates will be subject to federal estate tax, approximately 12 states have different rules involving taxation of estates and gifts, including exemption amounts below the federal threshold.

**Plan for low cost-basis property.** Maximize the continued benefit of stepped-up cost basis when property is transferred at death. For example, careful consideration should be made around lifetime gifts that may jeopardize a step-up in cost basis on property at death. When property is gifted, the party receiving the gift generally assumes the original cost basis.

**Certain trusts may help mitigate state income tax liability.** Consider certain trusts (such as incomplete gift non-grantor trusts) that may help those living in high-tax states shift income to states without state income taxes.

**Utilize trusts to take advantage of deductions.** Create trusts to own certain property and utilize deductions that may be eliminated or reduced for individual taxpayers, such as the deduction for investment fees.

**Tax rules may reverse after 2025.** Since the changes are scheduled to sunset after 2025, it is critical to work with a qualified estate planning professional on the possibility of the rules reversing at that point.

### Business owners

**Evaluate the tax status of the business.** Given the changes, business owners may want to consider what type of business structure or taxation method makes the most sense from a tax perspective. For example, an LLC can choose to be taxed as a flow-through partnership or as a C corporation.

**Work with a tax expert to make the most of the new 20% deduction.** The 20% deduction for qualified business income is a new addition to the tax code, so business owners should take steps to understand how it works and how timing of income and other actions may impact the deduction — both positively and negatively.

## The role of advice

With significant changes across most tax rules, individual investors as well as business owners may consider the importance of seeking professional advice in evaluating financial plans. Individuals accustomed to itemizing deductions, for example, will want to assess the impact of losing certain deductions and evaluate strategies on how to best achieve tax efficiency. Estate plans should be reviewed given the doubling of the exclusion amount. Business owners have access to a new 20% deduction for qualified business income and will want to learn how to optimize this deduction. With new rules around the taxation of pass-through income, some business owners may want to take a comprehensive look at their existing business structure for potential changes.

Since many of the provisions for individual taxpayers will expire after 2025, it is critical to consider how that possibility may affect planning strategies today given the possibility that the rules will change in the future.

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