Tax Reform Legislation: Changes, Impact, and Planning Considerations

Planning Update | January 2018

The Tax Cuts and Jobs Act of 2017, the long-awaited tax reform bill, was signed into law in December 2017. In this update, we will briefly highlight important aspects of this legislation related to all taxpayers and review the impact it will have on individual investors and business owners. We will also discuss some of the planning issues to consider given these changes.

The impact of these changes will vary depending on an individual's situation. Also, many provisions are ambiguous and will require clarification. We expect to receive additional guidance over the weeks and months to come. The provisions listed here are effective starting in 2018 unless stated otherwise. *The items in italics are scheduled to expire on December 31, 2025*. Therefore, any planning considerations should be evaluated with that in mind. The remaining provisions are not scheduled to expire unless otherwise noted.

Trust and Estate Tax Rates and Individual Rates and Brackets

Changes

- *For individuals, the new law provides for the same number of tax brackets, but with lower rates and different income thresholds. See the charts on page 2 for income thresholds associated with each bracket.*
- *The tax rates for trusts and estates have also decreased and now consist of only four brackets.*

  New rates: 10%, 24%, 35%, and 37%
  Old rates: 15%, 25%, 28%, 33%, and 39.6%

Impact

- Rates for qualified dividends and long-term capital gains are unchanged. The income thresholds for the capital gain brackets are no longer tied to the ordinary income brackets. See the following charts for a comparison of the capital gain and ordinary income brackets.
- Note that the top rate of 37% begins at $500,000 for single filers and at $600,000 for married filing jointly.
- Congress did not repeal existing Medicare taxes (the 0.9% additional payroll tax, or the 3.8% tax on net investment income) that apply to higher-income taxpayers. These apply when adjusted gross income (AGI) exceeds $250,000 (joint) or $200,000 (single).
- The Kiddie Tax is now tied to Trust and Estate tax rates. Taxable income of $12,500 results in a Trust tax of approximately $3,000 while the tax at individual rates would be approximately $1,400.

Planning Considerations

- Because taxable income is determined after applying deductions, it will be important for each taxpayer to evaluate how the loss of certain deductions may offset the benefit derived from the lower rates.
- Income tax planning for Trusts and beneficiaries is very important.

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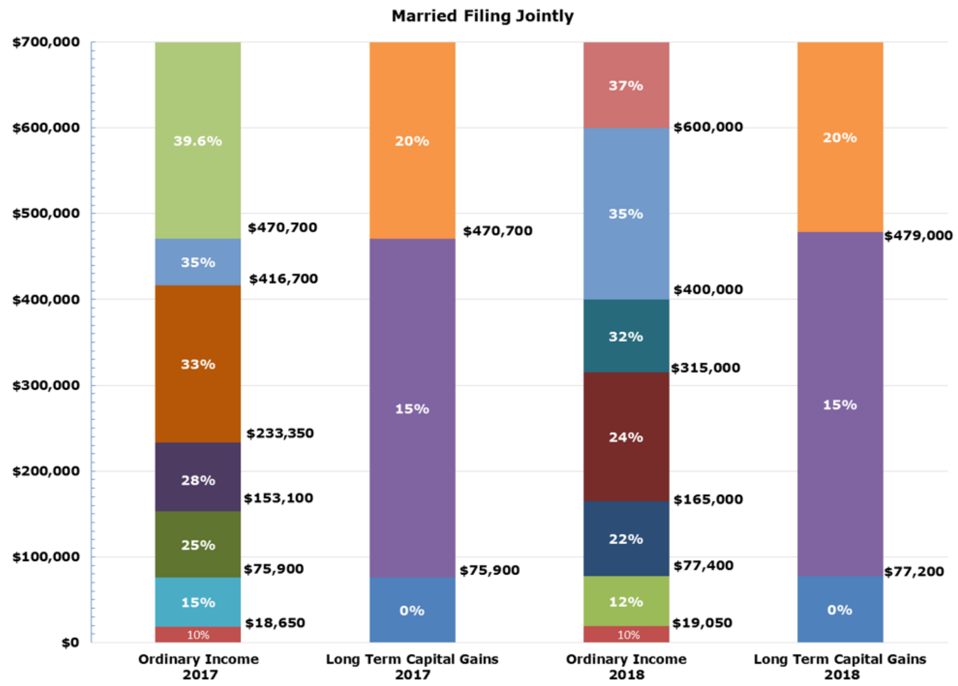

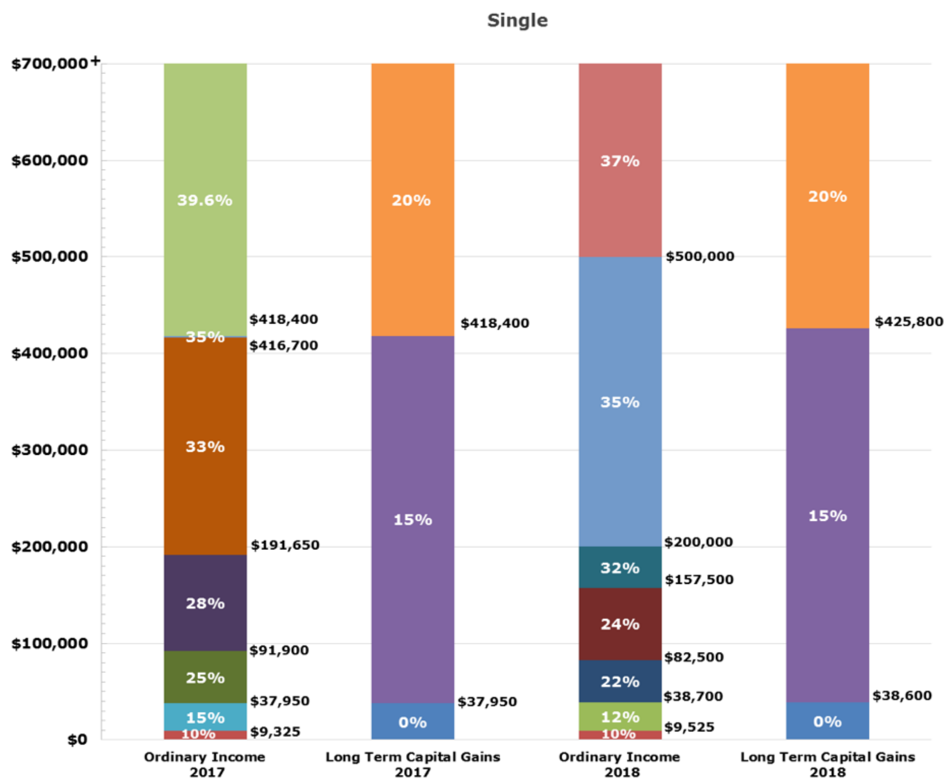

Source: Wells Fargo Advisors.

Deductions, Exemptions, and the Child Tax Credit

Changes

- *The standard deduction is nearly doubled to $24,000 for married filers and $12,000 for single filers* (standard deduction for individuals who are age 65 or older, or blind, is retained).
- *Personal and dependent exemptions (currently $4,050 per person) are eliminated.*
- *The deduction for state and local taxes is significantly changed. This deduction will be capped at $10,000 for the sum of state and local property taxes and income taxes (or sales tax in lieu of income tax). This limitation only applies to individual itemized deductions (Schedule A of tax return). Property taxes paid in carrying on a trade or business will not be subject to this $10,000 cap.*
- *Mortgage interest deduction limit on qualified acquisition debt is reduced from $1 million to $750,000. This means interest is deductible on loan balances up to $750,000 used to buy, build, or improve a primary home or one second home. This reduction applies only to debt incurred on or after December 15, 2017.*
    - *Includes home equity debt if the funds are used to acquire or improve the primary or secondary home.*
    - *Interest on home equity loans, other than the amount that was used to acquire or improve a qualified residence, is no longer deductible.*
- *Cash contributions to charitable organizations may now offset up to 60% of Adjusted Gross Income (AGI)—up from 50%.*
- *Deductions for investment management fees, tax preparation fees, and unreimbursed employee expenses (previously treated as miscellaneous itemized deductions) are eliminated* (rules regarding investment interest expense were not changed).
- Medical expenses exceeding 7.5% of AGI are deductible—down from 10%. This reduced limit applies only for 2017 and 2018.
- *Casualty losses are limited to those attributable to a federally-declared disaster area.*
- *The phase-out of itemized deductions for higher-income taxpayers is eliminated.*
- *The child credit increases from $1,000 to $2,000. The income level at which the credit begins to phase out also increases allowing more taxpayers to benefit.*
- Alimony payments are no longer deductible by the payer and not taxable to the recipient. This provision is effective for a divorce or separation instrument executed after December 31, 2018 or for changes to an existing instrument after that date, if the changes expressly provide that the new law should apply.
- *The individual Alternative Minimum Tax exemption and phase-out levels are increased, potentially allowing many more taxpayers to avoid AMT* (there was discussion about eliminating AMT for individuals, but it was not eliminated).

Impact

- For those who don't currently itemize, a larger standard deduction will likely be a welcome benefit.
- The repeal of many itemized deductions could mean that some taxpayers who previously itemized could find themselves limited to a standard deduction that is smaller than the amount they deducted under itemization.
- The $10,000 limit on state and local taxes (including property taxes) will be especially impactful to those in high tax states. Although taxpayers may still itemize, the impact of the limited deduction may offset savings from the changes to the tax brackets.
- The new 60% of AGI limitation on charitable deductions applies only to cash contributions to public charities. Taxpayers who have carryover of excess contributions to charity from prior years may be able to benefit from this provision.

Planning Considerations

- For taxpayers who are charitably inclined and over age 70½ , it will be important to evaluate whether it is more beneficial to make a contribution of cash, stock, or a qualified distribution from an IRA. The best strategy will not be the same for everyone.

<table>
<tr><td></td><td>Taxpayers will need to decide each year whether or not to itemize deductions. Some taxpayers may want to consider “bunching” charitable contributions into alternate years, with a view to qualifying for itemization at least some of the time. However, the cash flow impact on the taxpayer and the charity should be considered.</td></tr>
<tr><td>IRA Contributions and Conversions</td><td>Changes
The rule allowing a contribution to one type of IRA to be recharacterized as if made to another type of IRA is modified to exclude Roth IRA conversions. Normal IRA contributions may still be recharacterized.
Impact
Taxpayers who want to convert their Traditional IRA to a Roth IRA will need to carefully consider the consequences as they will no longer have the ability to change their mind.
Planning Considerations
A Roth conversion can still be a useful tax strategy in years with low taxable income or a market decline in retirement plan assets.</td></tr>
<tr><td>Education Tax Benefits</td><td>Changes
Qualified distributions from a 529 plan now allow up to $10,000 annually for elementary and secondary tuition including private and religious schools.
ABLE accounts (designed for disabled beneficiaries) may accept tax-free rollovers from 529 plans, up to the annual contribution limit for ABLE accounts.
Impact
Both 529 college savings plans and ABLE accounts become more attractive tools for meeting savings goals.
Planning Considerations
Consider additional funding for a 529 plan since the funds may now be used for tuition and other expenses for grades K-12.
Generally, it will be advisable to defer distributions from the 529 plan as long as possible to maximize tax-deferred growth. Consider paying tuition for elementary and secondary education directly to the institution.</td></tr>
<tr><td>Taxation of a Child’s Investment Income (“Kiddie Tax”)</td><td>Changes
Investment income of a child will be taxed at trust income tax rates rather than individual income tax rates.
Impact
For children under age 24 who are full-time students, investment income is no longer taxed at their parent’s rate but at trust rates. The top trust income tax rate is the same as the top rate for an individual. However, the top trust rate applies at a much lower level of income likely resulting in a higher tax bill under this new rule.
Planning Considerations
Review gifting strategies for younger family members along with the various vehicles available for holding funds in a child’s name.
Investment choices will be important to consider in order to control the amount and character of income generated while the child is subject to these rules.</td></tr>
<tr><td>Estate, Gift, and Generation-Skipping Taxes</td><td>Changes
The new law doubles the “applicable exclusion” to $11.18 million per person based on chained CPI inflation, effective in 2018. (The “portability” election, which permits a deceased spouse to transfer unused exclusion amounts to a surviving spouse, is unchanged. The rules providing a “step-up” in cost basis at death for capital assets are unchanged.)
This exclusion will continue to be inflation-adjusted in future years. Inflation adjustments will generally be lower than prior years due to a change in the calculation.</td></tr>
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Impact

- A married couple, with basic planning, should be able to transfer up to $22.36 million with no federal estate tax.

Planning Considerations

- The increase of the applicable exclusion provides a significant opportunity to review gifting strategies. Keep in mind, this provision is currently set to expire after 2025.
- Higher exclusions may tempt some individuals to overlook estate tax planning, resulting in potential missed opportunities. It could be a mistake to over-simplify your estate plan in reaction to the new law.
    - Instead of doing less estate planning, these higher thresholds could be viewed as an opportunity to do more.
    - In particular, higher generation-skipping exclusions provide an opportunity for multi-generational wealth preservation planning.
    - Furthermore, estate planning is not solely about estate taxes. There are many reasons to examine wealth transfer options that relate to family dynamics and overall asset protection.
- Existing estate plans for married couples often call for automatic, maximum funding of a “credit shelter” trust at the first spouse’s death.
    - This could result in less-than-optimal use of the deceased spouse’s exclusion, and sacrifice the opportunity for a “step-up” in cost basis at the surviving spouse’s death.
    - Estate plans created before 2013 should definitely be reviewed, and even recently created plans may need to be reconsidered in light of dramatically increased exclusions. Existing documents may include “formula clauses” that now result in all or more assets being used to fund credit shelter trusts, and little or no assets left to the surviving spouse.
- Individuals with charitable planning goals may benefit from adjustments to strategies and timing. For example, if no estate tax is owed, a charitable bequest does not result in any tax reduction. Perhaps lifetime giving strategies — which could provide an income tax deduction for itemizing taxpayers— should be evaluated as an option. In addition, it will be important to consider naming a charity to receive funds from IRAs, qualified retirement plans, or deferred annuities, as distributions from these assets would otherwise be subject to income tax if distributed to individuals.

Business Income and Deductions

Changes

- The tax rate for C Corporations is reduced from 35% to a flat rate of 21%.
- Corporate AMT is eliminated.
- *There is a new deduction of 20% for qualified business income of S corporations, partnerships, and sole proprietorships received by individuals, trusts, or estates.*
    - *Generally speaking, this special deduction is allowed against business profits, and does not apply to wages earned by the business owner.*
    - *The amount of the deduction generally cannot exceed 50% of wages paid by the business. However, capital-intensive businesses may qualify for an alternative limitation based on the acquisition value of capital assets.*
    - *If taxable income of the owner exceeds $415,000 (married filing jointly), this deduction is not available for businesses that provide services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, investment or brokerage services, or any business where the principal asset is the reputation or skill of one or more of its employees.*
    - *The deduction is reduced if the taxpayer’s income exceeds $315,000 (married filing jointly) or $157,500 (others).*
- *Taxpayers are also able to deduct 20% of income received as qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income.*
- 100% expensing of qualified business property is allowed for five years, after which it gradually phases-out. This applies to property placed in service on or after September 27, 2017.

- Increased limits for expensing are allowed under Section 179 and certain real property improvements are added as qualifying property.

Impact
- Current business entity selection may need to be reconsidered in light of these changes.
- Significant tax benefits are now available to businesses which have been waiting to invest in capital expenditures.
- These changes create significant opportunities for owners of pass-through entities and sole proprietors.

Planning Considerations
- Many questions remain about the details of how the deduction of 20% of qualified business income will apply.
- The type of business activity conducted will have a significant impact on whether and how a taxpayer benefits from the new deduction. Business owners will want to evaluate whether it is beneficial (and practical) to segregate "favored" and "unfavored" business activities into different entities.
- When considering a change of business structure or entity type, it is important to evaluate how the expiration of these new rules could impact the value of any particular strategy.
- As always, it is important that a tax advisor and attorney are involved to carefully weigh any decisions related to choice of business entity.

State and Local Taxes

Changes
- Some state tax provisions are tied to federal tax provisions. Each state will have to decide whether it will adhere to the federal changes.

Impact
- Differences in state and federal laws lead to additional complexity, record keeping, and tax preparation costs.
- Some states use federal taxable income as the starting point of their tax calculation. If a taxpayer's federal taxable income increases due to the loss of certain federal deductions, his or her state tax bill could increase even without any specific change to state law.

Planning Considerations
- Any tax strategies considered for federal tax planning purposes should also take into account the state tax impact.
- It is important to consider the impact of the new law when determining estimated tax payments for 2018.

Estate/Gifts/GST Tax
- The thresholds for state estate taxes are often considerably lower than the federal applicable exclusions.
    - A few states have "tied" their exemptions to the federal exclusion.
    - It will be important to monitor whether these states maintain that link, or choose to "decouple."
- It's not sufficient just to plan for the laws of the state where an affluent taxpayer lives.
    - To preserve family wealth effectively, it's increasingly important to consider the potential impact of state taxes in the places where heirs and beneficiaries live as well.

Next Steps

Many of the individual provisions listed here represent a significant change from prior law. In combination, the overall effects will vary widely among taxpayers. As time passes, we will have more clarity on the details as well as planning strategies to share. Now is the time to gather your advisor team. Your Abbot Downing team, along with your estate attorney and tax advisor, will be instrumental in determining what action steps may be appropriate for you in the short and long-term.

Disclosures

Please consider the investment objectives, risks, charges and expenses carefully before investing in a 529 savings plan. The official statement, which contains this and other information, can be obtained by calling your financial professional or the plan sponsor. Read it carefully before you invest. The availability of tax or other benefits from a 529 plan may be conditioned on meeting certain requirements.

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Any estate plan should be reviewed by an attorney who specializes in estate planning and is licensed to practice estate law in your state.

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