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The Tax Cuts and Jobs Act: Selected Issues for Individuals

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act, one of the most sweeping changes to the Internal Revenue Code since 1986. The marquee change made by the Act was the significant reduction in the tax rate paid by corporations. However, the Act had a significant impact on the way taxes will be paid by individuals as well.

These materials will provide an introduction and overview to what we feel are the most important changes affecting individuals. They in no way provide a comprehensive discussion, and the impacts of the Act are still being discussed and considered. Nevertheless, we hope they provide a good starting point.

But before getting into the details, we need to mention one point. A Senate rule, known as the "Byrd Rule," requires, in effect, that any law that has a negative fiscal impact beyond ten years requires at least 60 votes. Because the Republicans had only a bare majority, they had to pass a bill that, from a long-term perspective, was revenue-neutral. For that reason, a number of the changes made by the Act sunset at the end of 2025. Also, unless otherwise stated, rates and exemptions presented in this article are for married couples filing jointly.

I. Rates.

Rates for individuals went from 10, 15, 25, 28, 33, 35 and 39.6 percent last year to 10, 12, 22, 24, 32, 35 and 37 percent. This change sunsets after 2025. Capital gains rates stay at 15% and 20%, but are now indexed for inflation.

Personal exemptions, which previously were scheduled to be $4,150 per person in 2018, have been suspended through 2025.

But, in good news for taxpayers, the Act increased the child tax credit to $2,000 and (confusingly) increased the phase-out level to $400,000 from its previous $200,000.

The rates for trusts and estates are now 10, 24, 35 and 37percent. The top rate of 37% kicks in after $12,500 of income.

The "Kiddie Tax" previously taxed a child under the age of 19 (or 24 if a full time student) at the parents' rates, if their rates were higher. Under the Act, a child's earned income is taxed under rates for single individuals, and unearned income is taxed the same as trusts and estates.

The benefit to these rate changes in rates is not clear without looking as well at the changes in deductions. As will be clear, many taxpayers whose rates will go down will nevertheless pay more tax in 2018 because their deductions will go down even more.

Income Bracket Thresholds					
Tax Rate	**Single**	**Married Filing Jointly/ Surviving Spouse**	**Married Filing Separately**	**Head of Household**	**Trust/Estate**
10%	$0	$0	$0	$0	$0
12%	$9,525	$19,050	$9,525	$13,600	N/A
22%	$38,700	$77,400	$38,700	$51,800	N/A
24%	$82,500	$165,000	$82,500	$82,500	$2,550
32%	$157,500	$315,000	$157,500	$157,500	N/A
35%	$200,000	$400,000	$200,000	$200,000	$9,150
37%	$500,000	$600,000	$300,000	$500,000	$12,500

II. Deductions.

Perhaps the most important change for individuals is the increase in the standard deduction. Before the Act, the deduction was to be $13,000 in 2018. Under the Act, this deduction increases to $24,000 until 2026. This is important, because taxpayers are allowed to deduct either the standard deduction or the sum of all their itemized deductions. By increasing the standard deduction (and reducing certain itemized deductions, below), the Act will make it more beneficial for many taxpayers NOT to itemize. This could have a significant impact, for instance, on the number of taxpayers who deduct charitable contributions.

The next important change, especially for west coast states, is the limitation on state and local taxes. Previously, state and local income, property and sales taxes were deductible against federal income tax. Under the Act, however, through 2025 the total amount of such state and local taxes that can be deducted is $10,000. This limitation does not apply to property taxes paid or accrued in carrying on of a trade or business.

Mortgage deductions also are affected. First, new home equity loans are not deductible. Second, the deduction for mortgage interest is limited to $750,000 of underlying indebtedness. These limitations do NOT apply to debts incurred before December 15, 2017. These limitations end starting in 2026.

One deduction that becomes more useful under the Act is for medical expenses. Before the Act, such expenses were deductible only to the extent that they exceeded 10% of the taxpayer's adjusted gross income. Under the Act, that threshold is reduced to 7.5% of adjusted gross income. This change does not go away after 2025.

The charitable deduction under the Act remains largely unchanged except in one respect. Previously, contributions to a charity were limited to 50, 30 or 20 percent of modified adjusted gross income, depending upon the type of charity to whom the property was donated, and the type of property donated. Under the Act, the 50% limitation is increased to 60%. This increase also ends after 2025.

The miscellaneous itemized deduction, which includes fees for investment advice and which are subject to the 2% of AGI floor, have been suspended through 2025. This has led to a question about the extent to which it applies to trustee fees (discussed below).

In good news to higher income taxpayers, the limitation on itemized deductions known as the “Pease” limitation) under which such deductions are reduced by 3% of a taxpayer’s AGI if it exceeded a stated threshold, has been eliminated through 2025.

Personal and Dependency Exemptions (you, your spouse, and dependents)		
	Pre-existing law	**New law**
Exemption	$4,150	No personal exemption

Standard Deduction		
	Pre-existing law	**New law**
Married filing jointly	$13,000	$24,000
Head of household	$9,550	$18,000
Single/married filing separately	$6,500	$12,000
Additional aged/blind		
Single/head of household	$1,600	$1,600
All other filing statuses	$1,300	$1,300

Itemized Deductions		
	Pre-existing law	**New law**
Medical expenses	Yes, to extent expenses exceed 10% of AGI floor	Yes, 10% AGI floor reduced to 7.5% for 2017 and 2018
State and local taxes	Yes, income (or sales) tax, real property tax, personal property tax	Yes, limited to $10,000 ($5,000 for married filing separately)
Home mortgage interest	Yes, limited to $1,000,000 ($100,000 for home equity loan), one-half those amounts for married filing separately	Yes, limited to $750,000 ($375,000 for married filing separately), no home equity loan; the $1,000,000/$500,000 limit still applies to debt incurred before December 16, 2017
Charitable gifts	Yes	Yes, 50% AGI limit raised to 60% for certain cash gifts
Casualty and theft losses	Yes	Federally declared disasters only
Job expenses and certain miscellaneous deductions	Yes	No

The Alternative Minimum Tax, or “AMT,” was intended to prevent high income taxpayers from avoiding tax liability through the use of various deductions, exclusions and credits. Unfortunately, the exemption amount used to eliminate certain deductions was not indexed for inflation, so that a greater number of taxpayers were affected over the years. The AMT was not eliminated under the Act as had been initially proposed but instead has been retained with higher exemption amounts: it increased from $86,200 to $109,400. Although a discussion of how the exemption works and the AMT is calculated is beyond the scope of these materials, this exemption change will take a great number of taxpayers out of the AMT regimen.

The interplay of these provisions will produce interesting results. For example, a retired but still high-earning Oregonian who has paid off her mortgage may find herself with only $10,000 of itemized deductions (that is, the cap on state and local tax). This means that her charitable contributions would have to exceed $14,000 (if she was married filing jointly) in order for her itemized deductions to exceed the amount of her standard deduction. And, in this case, it would only be the charitable contributions in excess of $14,000 that would produce a benefit over the standard deduction (in other words, this taxpayer would have donate $15,000 in order to see a benefit of a $1,000 deduction over the standard). This analysis would change significantly if that taxpayer had medical costs in excess of 7.5% of her AGI and still had a mortgage. In other words, it's no longer clear who will and will not benefit from charitable deductions from a tax perspective.

III. <u>Deferred Income</u>.

Several more minor changes were made to retirement plans and deferred compensation, but are worth discussing.

First, taxpayers can no longer recharacterize contributions to Roth IRAs as contributions to a regular IRA within the same taxable year. This limits the flexibility of making a Roth contribution but keeping your options open if your tax situation changes.

Second, taxpayers who have certain stock options exercised starting on January 1, 2018 can elect to defer income recognized on the transfer of qualified stock. The rules regarding this deferral is beyond the scope of these materials.

Third, the amount that can be contributed to ABLE accounts has increased. An ABLE account is essentially a tax-deferred plan that benefits individuals with disabilities. Further, in some cases amounts from 529 plan accounts can be rolled over into ABLE accounts. This might be a way to redirect over-funded 529 plans into accounts for disabled family members.

Finally, 529 plan funds can now be used to pay private elementary and secondary school tuition, up to a $10,000 annual limit. Previously such funds only could be used for college expenses. At this point, it would seem to allow an Oregon parent to put in at least $4,000 into a 529 plan for her child, then turn right around and write a check to the elementary or high school. This probably won't be a big issue, since many of those parents already will have 529 plans and will already have taken advantage of the Oregon tax benefit.

IV. <u>Pass-Through Income</u>.

The Act provides a significant benefit to individuals with trade or business income from an S corporation, partnership, LLC taxed as a partnership or sole proprietorship. The individual is entitled to a 20% deduction on "qualified business income" (QBI) from such an entity. Investment income is generally not included in QBI, nor are reasonable compensation or guaranteed payments. For taxpayers earning more than $315,000, QBI also <u>excludes</u> income from the following trades or businesses: health, law, consulting, athletics, financial or brokerage services, or where the reputation or skill of an owner or employee is its principal asset.

There are many limitations and computational complexities involved in determining the amount of this deduction, beyond the scope of these materials, so the owner of a pass-through entity that wants to take advantage of the deduction should consult with her accountant.

As with most of the rest of the Act, this deduction is only available through 2025.

V. <u>Estate Planning</u>.

The big news here is that the Act has greatly reduced the number of taxpayers subject to Federal estate or gift tax. Specifically, the Act doubles the exemption for gift, estate and GST taxes. After inflation indexing, an individual can avoid estate tax on the first $11.2 million from her estate, and a married couple can shield $22.4 million. The estate, gift and GST taxes regimes all remain in place, and the estate, gift and GST tax rates remain at 40 percent. The change is effective through Dec. 31, 2025. Finally, taxpayers will continue to receive a full step-up in basis for inherited property included in the decedent's taxable estate.

On a more esoteric level, electing small business trusts, or "ESBTs," are one type of trust that is qualified to own S corporation stock (in general, S corporation shareholders must be individuals). The Act makes two changes to the ESBT rules. First, a nonresident alien individual may now be a beneficiary of an ESBT. Second, charitable contribution deductions for ESBTs are now calculated in the same manner as they are for individuals, not for trusts.

VI. <u>Taxes on Nonprofits</u>.

The Act made three changes to the taxation of nonprofits that won't have wide-ranging effects, but could have significant impacts on a few nonprofits.

First, nonprofits are subject to tax at the corporate rate on compensation paid to a "covered" employee (i.e., one of the five highest paid) in excess of $1 million, as well as on excess parachute payments.

Second, certain private colleges and universities have to pay a 1.4% excise tax on net investment income if they have assets of at least $500,000 per student.

Finally, unrelated business taxable income (or "UBTI") is now calculated differently: losses from one unrelated tax or business cannot be used to offset gains from another. Rather, gains and losses have to be calculated separately for each trade or business.

VII. <u>Trustee Fees</u>.

As discussed earlier, miscellaneous itemized deductions (those that are only deductible to the extent they exceed 2% of the taxpayer's AGI) are suspended through 2025. Personal representative and trustee fees are miscellaneous itemized deductions, and therefore also subject to the 2% floor, expect to the extent that those fees "would not have been incurred if the property [generating the tax] were not held in such trust or estate." Trustee fees attributable to investment advice, which is an expense individuals incur as well as fiduciaries, are subject to the 2% floor, but administrative expenses are not.

This leads to the question whether trustee fees as a whole are no longer deductible, or only those fees subject to the 2% floor. There's no clear answer; respected professionals and institutions have come down on both sides of the question (or have refused to take a position).