HD VEST
FINANCIAL SERVICES®

DISCUSSING THE TAX CUTS AND JOBS ACT THIS TAX SEASON

Duncan Gates, EA, CFP®, ChFC®, CLU®, RICP®
Practice Management Consultant/1040 Analyst Specialist

Over the last few months, tax reform has been perhaps the biggest legislative topic coming out of Washington. The House and Senate worked through their proposals, and jointly produced the Tax Cuts and Jobs Act of 2017. Now, just a few days before Christmas, President Trump has signed the bill into law.

As this bill becomes a law, it will mark the first major piece of tax legislation affecting individuals and corporations since the Reagan administration. While there are many pending changes to the tax code, advisors and clients need to keep in mind that these go into effect in 2018, and will not affect the upcoming tax season. However, the new tax law is almost guaranteed to be a conversational piece in your upcoming tax meetings. With that being said, this update is meant to discuss the most pertinent topics of the Tax Cuts and Jobs Act.

Tax Changes for Individuals

Let's start by looking at the tax brackets. While some early proposals minimized the number of brackets, the final bill maintained the seven tax brackets Americans have known over the last decade or so.

Single			
Current Law		Tax Cuts and Jobs Act	
10%	$0 – $9,525	10%	$0 – $9,525
15%	$9,525 – $38,700	12%	$9,525 – $38,700
25%	$38,700 – $93,700	22%	$38,700 – $82,500
28%	$93,700 – $195,450	24%	$82,500 – $157,500
33%	$195,450 – $424,950	32%	$157,500 – $200,000
35%	$424,950 – $426,700	35%	$200,000 – $500,000
39.6%	$426,700+	37%	$500,000+

Tax Changes for Individuals Continued

Married Filing Jointly			
Current Law		Tax Cuts and Jobs Act	
10%	$0 – $19,050	10%	$0 – $19,050
15%	$19,050 – $77,400	12%	$19,050 – $77,400
25%	$77,400 – $156,150	22%	$77,400 – $165,000
28%	$156,150 – $237,950	24%	$165,000 – $315,000
33%	$237,950 – $424,950	32%	$315,000 – $400,000
35%	$424,950 – $480,050	35%	$400,000 – $600,000
39.6%	$480,050+	37%	$600,000+

Looking at the chart, most of the tax rates have been lowered a few percentage points, reducing the marginal tax rates for most Americans. The tax brackets have also changed somewhat, meaning that some taxpayers have now fallen into a lower tax bracket.

Deductions and Personal Exemptions

Under the Tax Cuts and Jobs Act, the standard deduction has been increased while the personal exemptions have been repealed.

The standard deduction has been increased to $12,000 for single filers, $18,000 for heads of household, and $24,000 for taxpayers filing married filing jointly. These essentially doubled from the current deduction amounts of $6,500, $9,350, and $13,000 respectively.

Currently, the $4,050 personal exemption benefitted families the most when it came to deductions. However, going forward taxpayers lose the benefit of the personal exemptions. There is an expansion to the Child Tax Credit that can help offset some of this loss. Specifically, under the new rules, the Child Tax Credit has doubled to $2,000 per qualifying child and the income phase-out rule has increased to $200,000 for individuals and $400,000 for married couples (these are NOT indexed for inflation). This adjustment to the Child Tax Credit could offset some of the “loss” of the personal exemption.

A new feature of the Tax Cuts and Jobs Act is the $500 credit for dependents who are not “qualifying” children. This can apply to a number of people currently supported by taxpayers, including children over age 17, adult children with a disability, or elderly parents.

Itemized Deductions

During the proposal process, the most controversial issue was perhaps what to do with itemized deductions. Ultimately, not as many itemized deductions were eliminated as first feared, but they were curtailed more than some taxpayers hoped. In fact, when the more limited itemized deductions are combined with the expanded standard deduction, it's anticipated that only a very small percentage of households will itemize deductions in the future.[1]

The following is a summary of changes to itemized deductions:

- In previous years, taxpayers could deduct state and local property taxes, plus income or sales taxes, without limitation. Starting in 2018, there will be a cap of $10,000 of the state and local tax deduction

- With regards to the mortgage interest deduction, only the first $750,000 of mortgage debt will be deductible, down from $1,000,000. The good news is that this only applies to new mortgages after December 15, 2017; any mortgages taken out before then are grandfathered in to the $1,000,000 amount. The bad news is that after 2017, taxpayers will no longer be able to deduct interest on mortgage proceeds used for home equity indebtedness.

- The deduction for medical expenses was granted a two-year extension, allowing taxpayers to continue to deduct medical expenses that add up to greater than 7.5% of AGI. Note that starting in 2019, that percentage reverts to 10% as in previous years.

- For charitable contributions, the standard in the past has been limiting the deduction for cash contributions to public charities to 50% of taxpayer AGI. Under new tax law, this percentage increases to 60%. It's also of note that the Tax Cuts and Jobs Act requires documentation for donations of over $250.

- A significant change for itemized deductions regards the Miscellaneous Deduction section. In particular, ALL miscellaneous itemized deductions that were subject to the 2% of AGI floor have been repealed. This includes tax preparation fees, unreimbursed business expenses (such as the home office deduction), and the deduction of investment advisory fees.

Other Notable Changes to Individual Taxes

There are many other caveats of the Tax Cuts and Jobs Act that are of note for individual taxpayers:

Capital Gains and Qualified Dividends – The upside of this is the capital gains rates of 0%, 15% and 20% will remain in place. However, the capital gains and qualified dividends rates will use the old tax brackets, not the ones introduced in the Tax Cuts and Jobs Act. This could lead to some confusion as a change capital gains rates could fall in the middle of a tax bracket.

Roth Recharacterizations – Starting in 2018, the recharacterization of Roth conversions will no longer be allowed. However, note that there is no limit to the recharacterization of new Roth contributions. Also note that this should not affect the "backdoor Roth" strategy.

Estate Taxes – rather than the estate tax being repealed, it was actually doubled to $11.2M for individuals and $22.4M for married couples. This means that even fewer Americans will have to deal with estate taxes upon their death. In fact, the number of estates subject to Federal estate tax has fallen by nearly 95% since 2001, and is now estimated to be under 5,000 estates per year.[2]

Other Notable Changes to Individual Taxes Continued

529 Plans – The change to 529 plans is a positive one under the Tax Cuts and Jobs Act. As it stands today, proceeds can be used tax-free for college expenses. Starting in 2018, up to $10,000 per student can be used tax-free for the costs of public, private or religious elementary or secondary school.

Casualty Losses – In previous years, taxpayers that had a major personal loss (for example, due to fire, storm, shipwreck, or theft) that was not covered by insurance could deduct the loss, assuming the loss was in excess of 10% of AGI. Going forward, and through 2025, only those taxpayers affected by a official natural disaster (e.g., Hurricane Katrina) would be eligible for the deduction.

Alternative Minimum Tax (AMT) – The AMT exemption rules have been increased starting in 2018 from $55,400 for individuals and $86,200 for married couples, to $70,300 and $109,400, respectively. The phase-out amounts for AMT was also increased. What used to be $123,100 for individuals and $164,100 for married couples, is now increased to $500,000 and $1,000,000 respectively. The bottom line is that there should be less AMT exposure based on the increase in exemption amounts and phase-out ranges.

Alimony – Under the Tax Cuts and Jobs Act, alimony payments will no longer be deductible by payors, nor will it be reportable as income by payees. This provision of the law will only affect divorce agreements enacted after December 31, 2018.

1031 Exchanges – starting December 31, 2017, 1031 exchanges will only apply to real estate

Individual Mandate for Health Insurance – The mandate, which serves as a penalty for those taxpayers without health insurance, has been eliminated, effective in 2019

Tax Changes for Businesses

As with individual taxes, there are some significant changes to business tax law[3]:

- Starting in 2018, the corporate income tax rate is permanently reduced to 21%
- The Section 179 expensing cap increases from $500,000 to $1,000,000 and for the next five years, the full and immediate expensing of short-lived capital investments is allowed
- The deductibility of net interest expense will be limited to 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA) for a period of four years, then 30% of earnings before interest and taxes (EBIT) thereafter
- Net operating loss carrybacks are eliminated and carryforwards are limited to 80% of taxable income
- Enacts deemed repatriation of currently deferred foreign profits at a rate of 15.5% for cash and cash-equivalent profits and 8% for reinvested foreign earnings
- The corporate Alternative Minimum Tax (AMT) is repealed

Deduction for Pass-Through Entities

The most controversial business tax change in the Tax Cuts and Jobs Act deals with pass-through entities and the tax rate they will be charged. Starting in 2018, these business entities will be able to take advantage of a 20% deduction on "Qualified Business Income" (QBI). In other words, pass-through businesses will only be taxed on 80% of their pass-through income.

"Pass-through businesses" include partnerships, LLCs, S Corporations and sole proprietorships that file Schedule C. And while the deduction is claimed for pass-through business income, it is to be claimed on the taxpayer's individual tax return. However, something to note is that the Tax Cuts and Jobs Act explicitly states that the deduction will not be an above-the-line deduction for computing AGI, but rather a below-the-line deduction. It also is not considered an itemized deduction, so it can be claimed by those that claim the standard deduction.[4]

As a result of the QBI deduction, this will mark the first time that self-employed individuals (e.g. sole proprietors, or owners of partnerships, LLCs, or S Corporations) will potentially have a lower tax rate than employees that complete similar work. There is a rule included in the bill that is intended to prevent abuse of the pass-through tax break.[5]

- If the owner or partner in a pass-through business also draws a salary from the business, that money would be subject to ordinary income tax rates

- To prevent people from recharacterizing their wage income as business profits to get the benefit of the pass-through deduction, the bill places limits on how much income would qualify for the deduction

Another aspect of this rule that is important is that "specified service" businesses, including those performing services in the health, law, accounting, actuarial sciences, performing arts, consulting, financial services, and athletics fields, cannot take advantage of the QBI deduction. As with most laws however, there is an exception to this – single filers with income below $157,500 and joint filers with income below $315,000 can claim the deduction fully on income from service industries.

So What Now?

It's very likely that this will be a hot topic during the upcoming tax season, for both Advisors and clients. With tax reform as extensive as this, it will take a few months for everyone to digest it. And it will be a number of months before new tax savings strategies could be developed. But it also means that there are some important conversations to have, and potentially some important decisions to make.

The bright side of this is for Advisors and clients is that this is happening at the beginning of 2018. So there is plenty of time to make tax-savvy financial decisions and to adjust the client's goals- based financial plan in light of these tax changes. And if there is not a current financial plan in place, it's an ideal time to start one as new tax legislation is coming into place.

The next step for both Advisors and clients is to sit down sometime in 2018, either in tax season or afterwards, and discuss how these tax changes affect the client individually. My recommendation is to do this as early in 2018 as possible, giving you time to adjust throughout the year. Then after the discussion, adjust the goals-based financial plan, or create one, that will allow clients to adjust mentally, emotionally, and financially, to how the Tax Cuts and Jobs Act will affect them and their families.

References

1,2,4 - https://www.kitces.com/blog/final-gop-tax-plan-summary-tcja-2017-individual-tax-brackets-pass-through-strategies/

3 - https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/

5 - http://money.cnn.com/2017/12/15/news/economy/gop-tax-plan-details/index.html?iid=EL

The HD Vest affiliated companies exclusively provide financial products and services, and do not provide or supervise tax or accounting services.

HD Vest Financial Services® is the holding company for the group of companies providing financial services under the HD Vest name.
Securities offered through HD Vest Investment Services®, Member: FINRA/SIPC, Advisory services offered through HD Vest Advisory Services®,
6333 N. State Highway 161, Fourth Floor, Irving, TX 75038, (972) 870-6000 1609851 12/17