LEGAL ADVISORY

# PRACTICAL INSIGHTS ON TAX REFORM: IMPACT ON INDIVIDUALS


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On December 22, 2017, President Trump signed into law legislation, known as the Tax Cuts and Jobs Act ("TCJA"), which is the most extensive overhaul of the United States of the Internal Revenue Code (the "Code") in 30 years. In December, we issued a general advisory outlining the major changes in the Code made by TCJA. This advisory focuses on the provisions of TCJA that affect individuals. Unless otherwise noted, the changes described below are effective for taxable years beginning on or after December 31, 2017, and again, unless otherwise noted, are temporary and will expire on December 31, 2025, absent future legislative action.

## TAX RATES

TCJA retained the seven-bracket structure of prior law, although most income tax rates have been lowered. The maximum rate of 20% on long-term capital gain and qualified dividends remains unchanged, and the 3.8% tax on net investment income and 0.9% additional Medicare tax remain in effect for higher-income individuals.

The following tables compare the new individual income tax brackets imposed by TCJA with the ones that were effective through 2017:

### SINGLE FILERS

| New (Beginning in 2018) | | Prior (Through 2017) | |
|---|---|---|---|
| Rate | Income Bracket | Rate | Income Bracket |
| 10% | Up to $9,525 | 10% | Up to $9,525 |
| 12% | $9,526 - $38,700 | 15% | $9,526 - $38,700 |
| 22% | $38,701 - $82,500 | 25% | $38,701 - $93,700 |
| 24% | $82,501 - $157,500 | 28% | $93,701 - $195,450 |
| 32% | $157,501 - $200,000 | 33% | $195,451 - $424,950 |
| 35% | $200,001 - $500,000 | 35% | $424,951 - $426,700 |
| 37% | $500,001 and Over | 39.6% | $426,701 and Over |

### MARRIED FILING SEPARATELY

| New | | Prior | |
|---|---|---|---|
| Rate | Income Bracket | Rate | Income Bracket |
| 10% | Up to $9,525 | 10% | Up to $9,525 |
| 12% | $9,526 - $38,700 | 15% | $9,526 - $38,700 |
| 22% | $38,701 - $82,500 | 25% | $38,701 - $78,075 |
| 24% | $82,501 - $157,500 | 28% | $78,076 - $118,975 |
| 32% | $157,501 - $200,000 | 33% | $118,976 - $212,475 |
| 35% | $200,001 - $300,000 | 35% | $212,476 - $240,025 |
| 37% | $300,001 and Over | 39.6% | $240,026 and Over |

### HEAD OF HOUSEHOLD

| New | | Prior | |
|---|---|---|---|
| Rate | Income Bracket | Rate | Income Bracket |
| 10% | Up to $13,600 | 10% | Up to $13,600 |
| 12% | $13,601 - $51,800 | 15% | $13,601 - $51,800 |
| 22% | $51,801 - $82,500 | 25% | $51,801 - $133,850 |
| 24% | $82,501 - $157,500 | 28% | $133,851 - $216,700 |
| 32% | $157,501 - $200,000 | 33% | $216,701 - $424,950 |
| 35% | $200,001 - $500,000 | 35% | $424,951 - $453,350 |
| 37% | $500,001 and Over | 39.6% | $453,351 and Over |

### MARRIED FILING JOINTLY

| New | | Prior | |
|---|---|---|---|
| Rate | Income Bracket | Rate | Income Bracket |
| 10% | Up to $19,050 | 10% | Up to $19,050 |
| 12% | $19,051 - $77,400 | 15% | $19,051 - $77,400 |
| 22% | $77,401 - $165,000 | 25% | $77,401 - $156,150 |
| 24% | $165,001 - $315,000 | 28% | $156,151 - $237,950 |
| 32% | $315,001 - $400,000 | 33% | $237,951 - $424,950 |
| 35% | $400,001 - $600,000 | 35% | $424,951 - $480,050 |
| 37% | $600,001 and Over | 39.6% | $480,051 and Over |

### STANDARD DEDUCTION AND PERSONAL EXEMPTION

The standard deduction has increased to $12,000 for single filers (previously $6,350), $18,000 for heads of household (previously $9,350), and $24,000 for joint filers (previously $12,700), each indexed for inflation. TCJA retains the additional standard deduction for the elderly and the blind. The personal exemption was suspended through 2025.

Congress has stated that one of the overarching goals of TCJA was simplification. Raising the standard deduction was one of the changes intended to achieve this goal, as it was designed to encourage more individuals to take the standard deduction, rather than itemizing, which requires an additional schedule (Schedule A) to be included in an individual's tax return. Individuals now have added incentive to take the standard deduction because of the repeal of certain "miscellaneous itemized deductions," as discussed below.

### FAMILY TAX CREDITS

The personal exemption for dependents and the adoption tax credit were eliminated by TCJA.

The child tax credit was raised from $1,000 to $2,000 per qualifying child under the age of 17 and an additional credit of $500 was added for other dependents, both subject to a phase-out threshold of $400,000 for married couples and $200,000 for single filers. The refundable portion of the credit equals 15% of earnings in excess of $2,500 for each qualifying child (but the maximum refundable portion is now capped at $1,400 per qualifying child, as indexed for inflation). Social security numbers must be furnished by taxpayers to claim this credit.

## MISCELLANEOUS ITEMIZED DEDUCTIONS

Individuals who itemized their deductions under prior law were able to claim "miscellaneous itemized deductions" to the extent that the aggregate amount exceeded 2% of their adjusted gross income. These deductions were eliminated by TCJA. Among such deductions were expenses for the production of income, such as investment and appraisal fees, tax preparation expenses, and unreimbursed expenses attributable to the trade or business of being an employee.

As pointed out above, with the repeal of these itemized deductions and the raising of the standard deduction, there now are added incentives for individuals to take the standard deduction as opposed to itemizing.

## CHANGES TO OTHER DEDUCTIONS

Many other deductions available to individuals were affected by TCJA. The increase in the standard deduction will help to mitigate the effects of these changes (which often involved repealing the deduction), which were implemented to offset the revenue loss from the rate cuts. Specific changes to other deductions enacted by TCJA include:

- *State and local income, sales, and property tax deductions.* Deductions for state and local income, sales, and property taxes are now subject to a combined cap of $10,000. Individuals living in states with higher tax rates (for example, California and New York) will feel the impact of this change to the greatest extent, and some may even consider relocating to states with lower or no income tax. Note, however, that state and local income and property taxes are generally not subject to this new $10,000 cap if they are paid or accrued in carrying on a trade or business or for the production of income.
- *Home mortgage interest and home equity indebtedness deductions.* The deduction for home mortgage interest was retained by TCJA, although the amount is now limited to interest paid on the first $750,000 of principal, which is a reduction from the prior $1 million cap. This reduction does not apply, however, to indebtedness incurred on or before December 15, 2017 (to which the $1 million cap still applies). This deduction continues to apply to a taxpayer's principal residence and one other residence. The deduction for home equity indebtedness has been suspended, but if indebtedness incurred on a home equity line qualifies as "acquisition indebtedness," generally meaning that the proceeds were used to substantially improve or acquire the home on which the equity line is secured, interest on such indebtedness will be deductible to the same extent as home mortgage interest.
- *Medical expense deduction.* Out-of-pocket medical expenses in excess of 7.5% of adjusted gross income are deductible for the 2017 and 2018 tax years, with the floor reverting to 10% in 2019.
- *Charitable contribution deduction.* The cap on charitable contributions of cash to public charities was increased from 50% of adjusted gross income (AGI) to 60% of AGI. Previous advisory, *Practical Insights on Tax Reform: Impact on Exempt Organizations,* provides information on how TCJA will affect tax exempt organizations.
- *Moving expense deduction.* The deduction previously allowed for a taxpayer's moving expenses has been eliminated. This was an "above-the-line" deduction, meaning that taxpayers were able to take advantage of it, regardless of whether they itemized or took the standard deduction.
- *Alimony and separate maintenance payment deduction.* Effective for divorce or separation instruments executed after December 31, 2018, alimony and separate maintenance payments are no longer deductible by the payor spouse and are not treated as income to the recipient spouse. Existing alimony and separate maintenance agreements are grandfathered, generally along with any modifications to existing agreements. The treatment of child support was unchanged.

## WEALTH TRANSFER TAXES

*Gift taxes.* The federal gift tax was retained, but the exemption is now increased to $11.18 million per individual for tax years beginning after December 31, 2017 (with inflation indexing each year). Along with the majority of other changes, this provision will expire on December 31, 2025, absent future legislative action. Accordingly, individuals should consider making their larger gifts before 2026 to utilize this higher exemption amount which may not be extended.

*Estate and generation-skipping transfer taxes.* The estate and generation-skipping transfer tax exemptions were doubled from $5.6 million to $11.18 million (with inflation indexing each year).

*Potential "clawback".* TCJA directed the Treasury Secretary to prescribe regulations addressing the potential extra estate tax on the estate of a decedent who has made gifts using the $11.18 million exemption, but dies after December 31, 2025, when the estate tax exemption goes back to one-half of that amount. Congress apparently wants to eliminate such a potential extra tax.

## NEW PASS-THROUGH DEDUCTION FOR QUALIFIED BUSINESS INCOME

Owners of pass-through entities may be affected by, and other individuals may see as a planning opportunity, the new 20% deduction from taxable income for "qualified business income" received from certain pass-through business entities, which include partnerships, S corporations, LLCs, and sole proprietorships. This new deduction effectively reduces the maximum individual rate of 37% to 29.6% for income from pass-through entities that meets the definition of "qualified business income." Individual taxpayers also may be able to deduct 20% of qualified dividends paid by REITs, qualified publicly traded partnership income, and qualified cooperative dividends. Income that is paid as compensation to owners, however, is not eligible for the deduction.

## OTHER NOTABLE CHANGES

- *Section 529 plans.* Generally, distributions from section 529 plans used to pay qualified education expenses are tax-free. TCJA expanded the definition of "qualified education expenses" to include primary and secondary school expenses. Under prior law, only postsecondary schools were included. This change is permanent. Note, however, that state law in Massachusetts does not automatically conform with this change.
- *Individual alternative minimum tax.* The exemption for the individual alternative minimum tax (AMT), which was retained, was raised to $109,400 for joint filers (from $86,200) and $70,300 for single filers (from $55,400), and the phase-out threshold for the exemption was increased to $1 million for joint filers (from $164,100) and $500,000 for single filers (from $123,100). Because of these changes, along with the limitations on the deductibility of state and local taxes, as discussed above, the AMT is expected to apply to fewer individual taxpayers. These increases do not apply to estates or trusts.
- *Repeal of Affordable Care Act (ACA) individual mandate penalty.* Effective January 1, 2019, the ACA individual mandate penalty is effectively repealed (the amount of the penalty will be set at $0). This provision is permanent.

## GUIDANCE ANTICIPATED

The enactment of TCJA brings sweeping changes to the U.S. income tax system, and will require individual taxpayers to focus on both immediate and long-term planning (which is further complicated by the fact that many of the changes expire at the end of 2025). Although individual income tax rates generally have decreased, taxpayers may lose the benefits of certain deductions and credits that are being eliminated or materially limited. It is essential that taxpayers – and their advisors – incorporate these reforms into current and future tax planning.

Individuals and their advisors should keep an eye out for future guidance by the IRS and Treasury. The Department of Treasury issued an update of its Priority Guidance Plan on February 7, 2018 for the year spanning July 1, 2017 through June 30, 2018. This most recent version of the Priority Guidance Plan contains a list of items of guidance relating to TCJA that the IRS and Treasury plan to issue by June 30, 2018. On the list, among other items, is computational, definitional, and anti-avoidance guidance on the new 20% pass-through deduction and computation of estate and gift taxes to reflect changes in the basic exclusion amount.

**THIS ADVISORY WAS PREPARED BY ERIN E. WHITNEY, A MEMBER OF NUTTER'S TAX DEPARTMENT. LEARN MORE ABOUT THE TCJA BY CONTACTING A MEMBER OF OUR TAX DEPARTMENT. PLEASE STAY TUNED FOR THE NEXT ADVISORY IN OUR *PRACTICAL INSIGHTS ON TAX REFORM* SERIES. LEARN MORE ABOUT THIS LEGISLATION BY CONTACTING A MEMBER OF OUR TAX DEPARTMENT AT 617.439.2000.**