Tax Reform Law

Major Changes in Store for Individual Taxpayers

By Don Carpenter and Tim Thomasson

On Dec. 22, 2017, President Donald Trump signed into law the most significant overhaul of the U.S. tax code in over 30 years. Congress passed the bill under special procedures known as budget reconciliation, which allowed the Republican majority to advance the bill without the threat of a filibuster. But the rules of reconciliation also required that the bill not increase the deficit by more than $1.5 trillion during the 10-year period of the budget.

With this restriction, almost all the provisions affecting individual taxes will expire at the end of 2025 and the law will revert to the provisions in effect in 2017. The Republican majority has stated its intention to make these provisions permanent, but with mid-term elections in 2018, it remains to be seen if they will have the ability to do so.

Interestingly, even the prior title of the bill, "The Tax Cuts and Jobs Act" violated the reconciliation rules and in the end the bill was titled "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018;" not a title that will be quoted as the various provisions are analyzed.

This article is intended to be the first in a series of articles examining the major changes to the tax code resulting from the bill. Here we will focus on the individual tax provisions, while later articles will examine the provisions that affect pass-through entities, corporate taxes and the taxation of nonprofit organizations, as well as trusts and estates.

Taxes Reduced – Plain, But Maybe Not So Simple

During the debate and run-up to the passage of the tax bill, there was considerable focus on the lower corporate and pass-through tax rates as a windfall to high income taxpayers and investors at the expense of the broader population of low- and middle-income wage earners. However, this latter group also stands to benefit, as is evident from the following chart.

		Tax Due	
		Prior Law	New Law
Wages Earned		2018	2018
Smiths	$50,000	$8*	($1,361)*
Jones	$100,000	$7,608	$4,739
Williams	$200,000	$34,335	$26,819

(*assumes $100 earned income tax credit)

Let's consider three "typical" American families: the Smiths, the Jones and the Williams. All three families have two healthy, relatively happy children. None of the families itemize deductions and all earnings are from salaries and wages. As the chart illustrates, all three families will benefit from the new tax law.

Next, let's consider what drives these reductions before considering the more specific changes in the tax provisions that affect individuals.

Taxable Income Increases! It may come as a surprise, but the taxable income of all three families increases in 2018 when compared to prior law. The increase is driven by the interplay between the standard deduction for non-itemizers and the personal exemption allowance. Previously, each family would have received a standard deduction of $13,000 and personal exemptions of $16,600 ($4,150 for each family member). Under the new provisions, the personal exemption is eliminated, but the standard deduction is increased to $24,000 for married filing jointly. Therefore, taxable income increased by $5,600 for each of these families!

Fortunately, that's not the end of the story. The increase in taxable income is more than offset by two additional changes.

Tax Rates Reduced. For all the emphasis on the reduction of the corporate tax rate, the individual tax rates saw similar reductions both in terms of the applicable rates and the expansion of the income bracket to which the rates apply. Although there was no modification to the 10 percent bracket, the previous 15 percent bracket remained unchanged in terms of the 2018 applicable income level, but the rate was reduced to 12 percent, resulting in a reduction in tax of $1,750 for joint filers with taxable income of $77,400 or more. All three families benefitted from this rate reduction.

As the high earners on the block, the Williams family, with earnings of $200,000, would see additional reductions on the portion of their income in excess of $77,400 as the rate for the third tax bracket was reduced from 25 percent to 22 percent and the income level expanded to $165,000 (previously $156,150). The Williams saw a savings of $2,893 on their income in this bracket. And the portion of the Williams' income that exceeded $165,000 will now be taxed at 24 percent rather than 28 percent.

Child Tax Credit Increased. In addition to benefitting from the revised tax brackets and rates, all three families would see their tax liability reduced by an increased child tax credit. The prior credit of $1,000 per child is doubled to $2,000. Additional features of the child tax credit benefit the Smiths and the Williams specifically.

Note that the Smiths receive a refund of $1,361. This refund is payable even if it exceeds taxes withheld on earnings throughout the year. In the reconciliation between the House and Senate versions of the act, not only was the credit increased to $2,000 per child, but $1,400 of the credit is now refundable.

And the Williams would not have enjoyed the benefit of the child tax credit prior to tax reform; now they receive the full $2,000 tax reduction for each of their children. This benefit is attributable to a provision that increases the phase-out of the credit for married taxpayers filing jointly from $110,000 to $400,000. Similar increases to the phase-out apply to other categories of filers.

Earned Income Credit Remains Unchanged. Since its enactment in 1975, the earned income credit has been a mechanism for reducing the tax burden for lower-income wage earners. The calculation of the credit was not modified as part of this act. At their income level, the Smith family received a small earned income credit in both years.

Maybe It's Not So Simple

Before considering the specific provisions that affect taxpayers who itemize deductions, let's consider what filers and practitioners should glean from the three examples above.

First, there will be fewer tax returns filed with itemized deductions. By raising the standard deduction to $24,000 ($12,000 for single filers), many taxpayers will lack the necessary expenses to qualify for itemized deductions. But the increased standard deduction comes with a price: the loss of personal exemptions. For a couple with no children, the effect of the trade-off may not be beneficial.

In this example, let's assume that the Dinks (who have no children) expect wage income of $75,000 and itemized deductions of $23,000 comprised of mortgage interest, real estate taxes and charitable contributions. Now let's compare their taxable income both before and after the new tax act:

	Prior Computation	New Computation
Gross Income	$75,000	$75,000
Itemized Deduction	-23,000	---
Standard Deduction	---	-24,000
Personal Exemption	-8,100	---
	_________	_________
Taxable Income	$43,900	$51,000
Tax	$5,632	$5,739

The loss of the personal exemptions is not fully offset by the reduced tax rates and higher standard deduction.

Generally, the loss of the dependent exemption deduction for children is offset by the additional $1,000 tax credit for children younger than 17. Arguably, the new $500 dependent credit will at least partially offset the loss of the exemption deduction for children between the ages of 17 and 24 and for other dependents. With a

BY RAISING THE STANDARD DEDUCTION, MANY TAXPAYERS WILL LACK THE NECESSARY EXPENSES TO QUALIFY FOR ITEMIZED DEDUCTIONS.

personal exemption of $4,150, a couple filing jointly would have to be at a taxable income level in excess of the 25 percent bracket ($165,000) before the loss of the exemption outweighs the benefit of the enhanced credit. And this is without considering that previously the credit began to phase out at $110,000 of taxable income.

But I Have Always Itemized

With the higher standard deduction, this statement will no longer be true for many taxpayers. However, for those filers with itemized deductions in excess of the increased standard deduction, important changes to the specific categories of deductions are worth noting. The House version of the bill either eliminated or severely limited most categories of deductions. The Senate version took a gentler approach and the reconciliation saw a further softening as Republicans pushed their constituents' interests in exchange for their support of the bill. Let's take the individual deductions in the order they appear on Schedule A.

Medical and Dental Expenses. This category offers a classic example of how the reconciliation process had unexpected results in the development of the bill. The House version eliminated this category of deductions completely. But the final version of the bill not only retains this category, it offers additional benefits for 2018-2019. Prior to 2018, medical and dental expenses were only included as an itemized deduction to the extent that they exceed 10 percent of adjusted gross income. This floor is lowered to 7.5 percent for 2018-2019, before returning to the 10 percent level in 2020.

Taxes. The deduction for taxes paid likely generated more discussion and analysis than any other revision to the individual income tax provisions. The House version eliminated the deduction for state and local income taxes and sales/use taxes. It further limited the deduction for property taxes to $10,000 annually. Members of Congress from states that rely more heavily on income taxes objected to this approach and the final bill allows taxpayers to include all three categories of tax in the calculation of the $10,000 limit.

The bill includes a provision that will not allow cash basis taxpayers to prepay post-2017 state and local income taxes and thus include these amounts as a 2017 itemized deduction. This provision does not apply to shifting income taxes paid between years after 2017. The

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provision applies only to income-based taxes, so pre-paying property taxes was not prohibited. However, subsequent IRS guidance indicates that property taxes must be assessed by the tax jurisdiction if they are prepaid.

Mortgage Interest. The deduction for mortgage interest is retained, but limited to interest on $750,000 of mortgage indebtedness. The limit applies to debt incurred on or after Dec. 15, 2017. Debt in place by that date remains under the prior limit of $1 million even if subsequently refinanced. This provision is scheduled to expire in 2025 and interest would then be deductible on $1 million of mortgage debt even if financed after Dec. 15, 2027.

Interest on home equity debt is no longer deductible regardless of when the debt was incurred.

Charitable Donations. This category of deduction is not only retained, but expanded. Cash contributions are now limited to 60 percent of adjusted gross income rather than the prior limit of 50 percent.

Casualty and Theft Losses. Casualty and theft losses are now limited to only those losses incurred in a federally declared disaster.

Miscellaneous Deductions. Previously, other deductions, including unreimbursed employee business expenses, tax preparation fees, investment fees and safe deposit box rentals, were deductible to the extent they exceeded in the aggregate 2 percent of adjusted gross income. This category has now been eliminated.

Limitation on Itemized Deductions. For years prior to 2018, total itemized deductions were allowed only to the extent that they exceeded 3 percent of a threshold amount of adjusted gross income ($313,800 for married filing jointly in 2017). This limitation is no longer applicable.

All Is Not Lost

With the increased standard deduction and the limitations on certain categories of itemized deductions, it might appear that the ability to effectively utilize these expenses to reduce the personal income tax burden is severely restricted. This concern has been raised by nonprofit organizations that see the forfeited tax benefit to their donors as a disincentive to give. Homebuilders are also concerned that the limitation on mortgage interest coupled with the cap on taxes may weaken the demand for housing. But there is also some potential to maximize both the benefit of the higher standard deduction and itemized deductions with some planning and arguably some liquidity.

Let's take the Giver family as an example. They earn $150,000 annually and have the necessary two dependent children. In addition, they have $5,000 of mortgage interest, over $10,000 of combined taxes (state and local income, property, and sales) and give $15,000 in contributions. With $30,000 of qualified deductions, they should itemize. With some planning, they can structure their deductions to maximize the benefit. Without any adjustment, let's see what their tax liability would be in 2018 and 2019 (see above).

If the Givers family combined their charitable giving in one year (2018 in this case), their tax burden for the two years would be reduced by $1,980 as illustrated above. **Note:** once the $10,000 limit for taxes is met, there is no benefit to accelerating or deferring state income or property tax payments.

	2018	2019
Adjusted gross income	$150,000	$150,000
Itemized deductions	-30,000	-30,000
Taxable Income	$120,000	$120,000
Tax Before Credits	$18,279	$18,279
Less Child Tax Credit	4,000	4,000
Tax	$14,279	$14,279

	2018	2019
Adjusted gross income	$150,000	$150,000
Standard Deduction	---	-24,000
Itemized deductions	-45,000	---
Taxable Income	$105,000	$126,000
Tax Before Credits	$14,979	$19,599
Less Child Tax Credit	4,000	4,000
Tax	$10,979	$14,599

Under the above fact pattern, it would also be to the benefit of the Givers to incur optional medical expenses in 2018 to the extent these deductions will exceed 7.5 percent of their adjusted gross income.

This planning option existed with the pre-2018 standard and itemized deductions. However, the benefit was mitigated by the lower standard deduction amount. Either the filer consistently exceeded the lower standard deduction with expenses that could not be accelerated or deferred and if not, the tax savings from the standard deduction was less material.

What About Adjustments to Gross Income?

Although adjustments to gross income do not affect as many taxpayers, these items can be material to the determination of taxable income when they arise. The following two categories saw major revisions.

Moving Expenses. Historically, unreimbursed moving expenses were deductible from gross income and any reimbursement for such expenses was excluded from an employee's wages. With the exception of military relocations, any reimbursement will now be included in an employee's earnings and unreimbursed expenses are no longer deductible.

Arguably, this will increase the cost to employers for relocating their employees assuming the reimbursement will be grossed-up for the increased tax cost.

Alimony. The tax burden of alimony payments will shift from the recipient to the payor for any divorce settlements executed after 2018, as payments will no longer be deductible by the payor and are not included in gross income of the recipient. For divorce settlements prior to 2019, the payor continues to deduct the alimony and the recipient includes the payment in computing adjusted gross income.

Any modifications to pre-2019 settlements can be included in the new provisions if the modification expressly elects to apply them.

This provision does not revert to prior law at the end of 2025 and its implementation is delayed one year until 2019. The alimony revisions have the effect of shifting the tax burden to the payor, who is typically viewed as more economically capable of bearing the burden. Arguably, the tax impact should also be considered by a judge or arbiter when determining the amount of alimony due. It is possible for an individual with more than one divorce to have alimony payments under both provisions if one divorce settlement is pre-2019 and another is post-2018.

Determining the Tax Liability

We considered the change in the tax rates and brackets earlier, but the following are other changes in determining tax liability that should be noted.

Healthcare Mandate. Although the requirement that individuals and families must have heath care remains, the penalty for non-compliance is reduced to zero. For a family of four, the minimum penalty would have been $2,085. This provision is not effective until 2019, but does not revert to prior law at the end of 2025.

Alternative Minimum Tax. Although repealed for corporations, the alternative minimum tax remains for individuals. However, the exemption amount increases from 84,500 to $109,400 for married filing jointly (54,300 to $70,300 for single filers). The phase-out thresholds increase to $1,000,000 for married filing jointly and $500,000 for single taxpayers.

Marriage Penalty/Head of Household. The new tax rates eliminate the "marriage penalty" in the lowest five tax brackets. The sixth bracket tops out at $500,000 for single taxpayers and all income in excess is taxed at 37 percent, while this bracket tops out at $600,000 married filing jointly taxpayers.

Taxpayers utilizing the head of household filing status do not fare as well. Beginning with the 24 percent rate bracket, the income thresholds for single taxpayers and head of household taxpayers will now be identical. Prior to 2018, the income thresholds were more generous for head of household filers at every rate bracket.

Kiddie Tax. Unearned income for dependent children will now be taxed at the rates applicable to equivalent income for trusts and estates. Previously, it was taxed at the higher of the child's or the parents' tax rate. Because the tax brackets for trusts and estates are much more compressed than individual tax rates, the tax burden on investment income of children could actually increase.

Tax on Investment Income. The tax rate on capital gains and dividends remains at 0 percent, 15 percent, or 20 percent, depending on the taxpayer(s) applicable tax bracket. The 3.8 percent tax on net investment income also remains in place. ■

What is Inflation? A Provision That Has Drawn Little Attention

Within the computations of individual income tax liability, items such as tax brackets and standard deductions are indexed for inflation. Annual inflation adjustments have historically been based on the Consumer Price Index (CPI).

However, beginning in 2018, the indexation will be based on chained CPI, which moderates CPI by considering purchasers' options to substitute cheaper goods in times of inflation. This will result in lower annual adjustments to items subject to indexation.

Unlike most of the individual tax changes in this new tax law, this provision does not sunset in 2025 and is the reason analysts often comment that taxpayers will experience a tax increase if the new provisions are not extended.

Review Withholding

After considering all the changes discussed in this article, a wholesale review of tax withholdings on earnings should be undertaken early in 2018. Married individuals should consider the effect of the new tax brackets on combined wages. In addition, the elimination of personal exemptions, higher standard deductions and child tax credits, as well as revisions to itemized deductions, can significantly change withholding obligations.

With the bill being enacted during the final weeks of 2017, payroll systems may not have the changes fully implemented until early February. Taxpayers should then look at withholdings and adjust accordingly.

Although not exhaustive, this article has focused on the most material provisions of the new tax bill that affect individual taxpayers, particularly when a significant portion of earnings is from salaries and wages. Later articles will consider the changes affecting pass-through entities, which also affect individual tax returns, particularly those of sole proprietors and partners.

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