TC Wealth Partners LLC

Trust Company of Illinois

AN IN-DEPTH ANALYSIS OF THE TAX REFORM PACKAGE (HR 1 TAX CODE)

How your taxes will change in 2018.

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On December 22, President Trump signed into law HR 1, commonly known as the "tax cuts and jobs act." It is the largest tax reform bill since the 1986 reform by President Ronald Reagan. While initially it promised to be simpler than the incredibly complex IRS tax code, the new tax reform is far from simple. After multiple versions of the bill made their way through the House and the Senate, a final 1000-page version emerged. The following are initial observations that we feel are important to consider in conjunction with your current financial plan.

1. INCOME TAX RATES

Overall, the new bill lowers the marginal income tax rates for both individuals and businesses. It is important to fully understand the changes to the tax code when evaluating if there is an overall reduction or increase in a taxpayer's tax liability. Due to changes in aspects of the code, the reduction in the tax rate does not alway equal a reduction in the total amount of taxes due.

2. STANDARD DEDUCTION INCREASE

Change: The amount of the standard deduction will increase from $6,500 for single taxpayers ($13,000 for married filing jointly) to $12,000 for single taxpayers ($24,000 married filing jointly).

What it means: This may cause many taxpayers to elect not to itemize deductions, due to the additional decrease in itemized deductions available to taxpayers. This will ultimately simplify the tax preparation process for many households that were previously itemizing deductions on their annual return.

3. REMOVAL OF PERSONAL EXEMPTION

Change: The current personal exemption that all taxpayers are entitled to (phased out at high income levels) will be suspended through the year 2026. The old law allowed an annual exemption of $4,150 for 2018 subject to phase-out for higher incomes.

What it means: Previously, personal exemptions were available to the taxpayer, the taxpayer's spouse, and any of the taxpayer's dependents included within the household for $4,150 each. The suspension of the exemption will inherently raise the taxpayer's Adjusted Gross Income (AGI), particularly in households with multiple dependents. It is important to note that there is an attempt to negate this suspension with the increase of the child tax credit.

4. NEW INFLATION MEASURE

Change: Traditionally the IRS has used CPI-U (Consumer Price Index for all Urban Customers) to determine the amount of annual increase for tax bracket amounts, standard deduction amounts, and various other tax figures. With the new law, the IRS will use the C-CPI-U (Chained Consumer Price Index for all Urban Customers).

What it means: In general, the C-CPI-U grows at a slower pace than the traditional CPI-U because it takes into account the consumer's ability to

substitute between goods relative to prices. This will decrease the amount of annual inflationary adjustments that the IRS imposes on certain limits and thresholds subject to inflationary increases.

5. KIDDIE TAX MODIFICATION (NEW TRUST RATES)

Change: The current "kiddie tax" provisions are designed to prevent the placing of income-producing assets in a minor's name due to their lower tax bracket. In general, the pre-act law required that a child's net unearned income in excess of $2,100 be taxed at the parents' tax rate, which is typically higher than the child's. The new law will require the income that was typically taxed at the parents' tax rate to be taxed at the tax bracket applicable to trusts and estates.

What it means: In general, this will make the strategy of placing income-producing assets into a child's name for tax purposes less valuable than it was in the past. It will be necessary to compare the benefit of moving to the child's tax rate, with the negative impact of utilizing the trust tax rate for income over the threshold.

6. CAPITAL GAINS – UNCHANGED

7. INCOME FROM PASS-THROUGH ENTITIES – NEW "QUALIFIED BUSINESS INCOME"

Change: Income from pass-through entities such as sole proprietorships, partnerships, limited liability companies (LLCs), and S-Corporations are not subject to an entity-level tax; instead, all income "flows through" to the taxpayer onto their personal income tax return. The new tax law will allow pass-through entities to deduct from qualified business income:

a) The lessor of the "combined qualified business income amount" of the taxpayer, or 20% of the excess of the taxable income of the taxpayer for the year over the sum of net capital gain and the aggregate amount of the qualified cooperative dividends of the taxpayer for the tax year; plus

b) The lessor of 20% of the aggregate amount of the qualified dividend of the taxpayer for the tax year, or the taxable income of the taxpayer for the tax year.

What it means: Generally, this will allow taxpayers participating in pass-through business activities to receive a deduction in income of approximately 20% of income. This will apply to all pass-through entities, including businesses that are focused on real estate (such as real estate investment trusts (REITS). The additional deduction from income will effectively lower the amount of taxable income imposed on pass-through entities. It is evident that this was the section of the tax bill aimed at assisting "the little guy"-- businesses that are not affected by the lowering of the corporate rates.

8. TREATMENT OF CARRIED INTEREST – PARTNERSHIP INTEREST HELD IN CONNECTION WITH PERFORMANCE OF SERVICE (LARGE EFFECT ON HEDGE FUNDS)

Change: In general, receiving a capital interest for services provided to a partnership result in taxable compensation received by the recipient. Currently, under a safe harbor rule, profits received in exchange for services provided are not taxable if the recipient is only entitled to share in gains and profits after the date of issuance. When the taxpayer has received a cash distribution from the capital interest, the distribution is currently taxed at favorable capital gains rates. The new law will require taxpayers to hold their capital interests for a minimum of three years before they are eligible to receive the favorable tax rates.

What it means: In general, to receive favorable tax rates, a taxpayer must hold a capital interest for services for three years to obtain the favorable capital gains treatment. An example of this is the way in which typical hedge fund managers are compensated. Hedge fund managers are typically compensated based on a percentage of profit amount (i.e., 20%) and a fee based on the total market value (2%). The new law will disallow this income from being taxed at the favorable capital gains rate unless the asset is held for at least three years.

9. DEDUCTION FOR PERSONAL CASUALTY AND THEFT LOSSES SUSPENDED (STILL ABLE TO NEGATE GAINS)

Change: In general, individual taxpayers were allowed to claim an itemized deduction for uncompensated personal casualty losses arising from fire, storm, shipwreck, other casualty, or theft after a minimum amount. The new law will suspend personal casualty and theft deductions that are not part of a federally-declared disaster. However, taxpayers will still be allowed to deduct losses from casualty losses and theft to the extent that there are gains as a result of the loss.

What it means: This is an additional decrease in the itemized deductions available to taxpayers, and it will inherently increase the amount of taxes that are collected. If a taxpayer experiences a significant loss, it will no longer be reflected as a reduction of their taxable income.

10. CHILD TAX CREDIT INCREASE

Change: The child tax credit (a direct reduction in tax liability) allows taxpayers to claim for qualifying children under the age of 17. Previously, the credit was limited to $1,000 per qualifying child and it began to be phased out at income levels of $110,000 for married couples filing jointly ($75,000 single taxpayers). The new law increases the phase-out threshold to $400,000 for married filing jointly ($200,000 for all other taxpayers) as well as increases

the credit from $1,000 to $2,000. The new law also includes a credit for non-child dependents (such as elderly family members) up to $500. It is important to note that taxpayers will be required to provide social security numbers for any child or non-child dependent being claimed.

What it means: This change in the law can be seen as a response to the removal of the personal exemption. Due to the increase in availability and the amount of the credit, more taxpayers will be able to claim the tax credit. This is another example of the give-and-take nature of the tax law changes: one credit/deduction is reduced or eliminated, but a related credit/deduction is increased.

11. STATE AND LOCAL TAX DEDUCTION LIMITATION

Change: Prior to the new legislation, taxpayers were allowed to deduct multiple types of taxes paid at the state and local levels as itemized deductions from income, including real estate taxes, state income taxes, and/or sales taxes paid. The new law limits the deduction to $10,000, a substantial reduction for many tax payers. At the final hour, a provision was added to the law, disallowing the prepayment of income taxes for a future year.

What it means: This will affect many households, as it is an itemized deduction that incentivized many taxpayers to itemize deductions rather than take the standard deduction. It is another indication that many taxpayers who were itemizing deductions on their return may begin to take the standard deduction. Overall, this could impact people who live in populated areas with relatively high property taxes. What about those who pre-paid 2018 taxes in late 2017 hoping to take advantage of the prior law? A prepayment provision added at the final hour clarified that 2018 state or local income taxes paid in December 2017 are disallowed as a deduction. However, this provision does not affect property taxes. At this time, 2018 property taxes are considered deductible if assessed and paid in 2017.

12. MORTGAGE AND HOME EQUITY LOANS

Change: Prior to the new law, taxpayers could deduct (itemized) interest paid on a mortgage for a primary or secondary residence. The deduction was also available for interest paid due to home equity debt (i. e., home equity line of credit) for expenses directly related to the property. The deduction was available on debts up to $1,000,000 for married couples ($500,000 single taxpayers). The new law continues to allow the deduction of interest, but lowers the maximum amount of debt to $750,000.

What it means: Although many taxpayers will not feel the effects of this, taxpayers with debts over $750,000 but under $1,000,000 will realize a lowered deduction amount. It is also important to note that this is an itemized deduction, and due to other changes within the bill, many households will no longer be itemizing deductions.

13. CHARITABLE DEDUCTIONS

Change: Prior to any changes, personal charitable contributions that were made as cash were deductible as an itemized deduction up to 50% of adjusted gross income (AGI). The new law adjusts this amount to 60% of AGI. If a charitable deduction is made in excess of the AGI threshold, the taxpayer is allowed to “carry forward” the deduction for up to five years.

What it means: This will allow taxpayers making charitable cash donations to qualified charities to deduct a greater percentage of AGI as an itemized deduction, which will incentivize taxpayers to make greater charitable donations than in the past.

14. ALIMONY DEDUCTION

Change: Prior to the new law, alimony and separate maintenance payments made from one spouse to the other were deductible by the payer and includable in the recipient’s income. For any divorce or separation agreements executed after December 31, 2017, any alimony paid is not deductible by the payer and not included in the recipient’s income.

What it means: Although this can be construed as a way to hurt the more financially stable party in a divorce or separation agreement, it is important to realize that future agreements will take the changes to the law into account when completing the valuation for a divorce or separation agreement. This means that the amount of alimony paid will likely be adjusted to an after-tax basis when creating the agreements. Essentially, this would not penalize or benefit either party, but increase the overall amount of taxes paid by both parties by ensuring that the party with the higher marginal tax rate is not allowed to deduct alimony from their income.

15. MISCELLANEOUS ITEMIZED DEDUCTIONS

Change: Prior to the new law, taxpayers were allowed to deduct certain miscellaneous expenses such as unreimbursed job expenses, investment expenses, tax preparation fees, fees to fight the IRS, gambling losses, and hobby expenses to the extent that they exceeded a floor of 2% of adjusted gross income (AGI). The new law suspends these itemized deductions entirely.

What it means: This is another hit to the common itemized deductions that made it favorable for many households to itemize deductions rather than take the standard deduction. Again, without these and other deductions previously available, many households will find themselves taking the increased standard deduction, simplifying their overall tax filing process.

16. OVERALL LIMITATION ON ITEMIZED DEDUCTION "PEASE LIMITATION"

Change: Prior to the new law, high-income taxpayers who itemized their deductions were subject to a "Pease limitation"-- a limitation on common overall deductions. For taxpayers with income exceeding the threshold, a reduction of 3% of the taxpayer's adjusted gross income (AGI) was applied to the overall deduction amount not to exceed 80% of all itemized deductions. The new law has suspended this overall limitation, making the income threshold irrelevant.

What it means: This change is aimed to benefit high-income taxpayers by allowing them an increased amount of itemized deductions. It will incentivize high-income earners to take advantage of itemized deductions, and overall create a reduction in the amount of taxes paid by high-income earners.

17. MOVING EXPENSE REIMBURSEMENT

Change: Previously, all taxpayers were able to deduct moving expenses incurred as a result of a job change as "above the line" deductions for adjusted gross income (AGI)—provided that the new workplace was at least 50 miles away from the former residence. The new law suspended this deduction entirely, eliminating a common "above the line" deduction for many households going through transitions while starting a new job.

What it means: This change will have an effect on households relocating due to a change in jobs. It will likely not disincentivize taxpayers enough to stop them from taking a job that requires relocation, but is another suspension of a common reduction in income that many American households going through a transition take every year.

18. SHORT-TERM REDUCTION TO MEDICAL EXPENSE ITEMIZED DEDUCTION

Change: Under the prior law, taxpayers were able to deduct medical expenses for themselves or other dependents once the expenses exceeded a general threshold of 10% of adjusted gross income (AGI) (7.5% for those over a certain age). This deduction was also adjusted if the taxpayer was subject to the alternative minimum tax (AMT). Beginning January 1, 2017, the general threshold has been reduced to 7.5% for all taxpayers, and the AMT reduction is eliminated until Jan. 1, 2019.

What it means: Although it is important to remember that many taxpayers will no longer itemize deductions and instead will take the standard deduction, this could be a significant adjustment for those who have large annual medical expenses. It will allow taxpayers to reduce the amount of their taxable income.

19. REPEAL OF OBAMACARE MANDATED MINIMUM HEALTH INSURANCE COVERAGE

Change: Prior to any changes, the Affordable Care Act (commonly known as Obamacare) required all individuals to maintain "minimum essential coverage" for health insurance, or face a penalty on their tax returns. The new law reduces the penalty amount for insufficient coverage to $0.

What it means: This change will impact the health insurance industry. It is estimated by the Congressional Budget Office (CBO) that this change will save the U.S. government approximately $338 billion over a 10-year window due to taxpayers not taking advantage of the government subsidized insurance coverage. It is also important to note that the additional tax created by the Affordable Care Act of 3.8% on net investment income and 0.9% Medicare tax, originally created with the intent to fund the act, remains intact.

20. ESTATE AND GIFT TAX EXEMPTION INCREASE

Change: Prior to any changes, individuals were allowed to transfer up to $5.6 million ($11.2 million for married couples) adjusted for inflation through either gifting or transfer through their estate before realizing any gift or estate taxes. The new law increases this exemption amount to $11.2 million ($22.4 million for married couples).

What it means: This change will significantly reduce the number of taxpayers who are required to pay both gift and estate taxes at a federal level. However, when evaluating estate planning strategies, it is important to consider that many states have instituted their own estate and gift tax exemption amounts at a lower level than the federal level.

21. ALTERNATIVE MINIMUM TAX – RETAINED WITH HIGHER EXEMPTION AMOUNTS

Change: The alternative minimum tax (AMT) was targeted at high-income earning taxpayers who have a low effective tax rate due to a large number of deductions from income. The tax adjusts taxable income by removing deductions and preferences to increase the level of taxable income. Initially, many believed the AMT would be taken out of the tax code. However, it remains, and the threshold of income at which the AMT tax applies was adjusted from $86,200 for married taxpayers filing jointly ($55,40 for unmarried individuals) to $109,400 for married taxpayers ($70,300 for unmarried individuals).

What it means: For many taxpayers, this will mean that the alternative minimum tax no longer applies. Furthermore, with the reduction in the number of deductions available to taxpayers, the adjustment for AMT taxable income will be less significant for many. Overall, this will reduce the tax liability imposed by the alternative minimum tax.

22. 529 COLLEGE SAVINGS ACCOUNTS – EXPANDED EXPENSE DEFINITION

Change: Under the old tax law, expenses allowable for 529 education

accounts were limited to qualified higher education (post high school) expenses, including tuition, fees, books, supplies, and reasonable room and board. If a taxpayer used funds in a 529 account for non-qualified expenses, taxes and penalties applied. The new law will allow up to $10,000 annually for expenses associated with elementary or secondary public and private school as well as certain expenses associated with homeschooling.

What it means: This expansion of eligible expenses for a 529 account will make establishing 529 accounts for children more appealing, especially if the child intends to enroll in private primary education.

23. ROTH IRA CONTRIBUTION RECHARACTERIZATION

Change: Prior to the new tax law, individuals were able to make a contribution to an IRA (Traditional or Roth) at the beginning of the tax year, and then recharacterize the contribution after the end of the tax year (but before filing their personal income tax returns). The new tax law has disallowed the recharacterization of a Roth IRA conversion completed at the beginning of the year.

What it means: This means that a common tax strategy of completing a Roth IRA conversion at the beginning of the year, and then recharacterizing it at the end of the year based on how the market performed, is no longer an available tax planning strategy.

24. LIMIT ON EMPLOYER'S DEDUCTION FOR FRINGE BENEFIT EXPENSES

Change: Under the old tax law, employers were able to deduct 50% of expenses related to meals and entertainment incurred while conducting business. The new law disallows 100% of entertainment expenses incurred, and more specifically defines meal expenses that are deductible (such as, meal expenses must be provided on the premises of the employer). The new law also eliminates the ability of the employer to deduct fringe benefits for employee transportation.

What it means: This will eliminate the subjectiveness of whether entertainment expenses incurred by an employer are deductible expenses. It will also reduce the deductions that employers take relative to meals, entertainment, and transportation.

In conclusion, this tax code overhaul is large and complex. Although most tax payers will likely see a decrease in the amount of their annual tax liability, it is important to consider the specifics of your situation when developing any personalized tax strategy. Only when looking at your entire financial picture are you able to understand the real scope and benefits of tax planning. It is also important to note the way the final bill was written and the way the IRS will enforce the specific changes is still unclear. It will likely take years until all of the dust settles and proper guidance is given by the IRS on the changes.

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