

# THE Good Advisor

## Planning for Change: The Impact of the Tax Cuts and Jobs Act

Steve Stepp had a plan for success that worked for him. Stepp founded the National Audio Company in 1969. The company was the leading manufacturer of cassette tapes during the 1980s—a period when every popular song was recorded on a cassette tape.<sup>1</sup> Then came the introduction of compact discs—the first nail in the coffin of the cassette industry.

While other companies shifted to CDs, Stepp recognized the ongoing demand for cassettes and broadened his customer base to include schools, churches, and books on tape. By 2005, Stepp saw an opportunity to expand by purchasing cassette-making equipment for pennies on the dollar from companies who had exited the market. Despite the rise of digital downloads, segments of the market once again turned to cassettes, and National Audio was there to supply them.

While some companies abandoned their plans when faced with unforeseen challenges, Stepp planned for change, embraced the market, and made it work for him. As we look to the future, we know we must plan for change as well. The recent Tax Cuts and Jobs Act (TCJA) ushered in significant change in the form of new tax rates, deductions, and tax treatment for both individuals and business entities.

It is easy to be anxious about a big change. However, like Stepp, we can turn uncertainty into opportunity by examining the changes and looking explicitly at how the new law will actually impact taxpayers.

In this issue of *The Good Advisor* we look at some key provisions of the Tax Cuts and Jobs Act and their impact.

### How Business Taxes Have Changed

#### The Corporate Tax Rate

Without a doubt, the largest modification in the TCJA is the reduction in corporate tax rates. Rates moved from eight tax brackets with a top rate of 35% to one flat rate of 21% for tax years beginning in 2018.<sup>2</sup> Unlike many changes in the TCJA that are only valid through 2025, the flat corporate tax is a permanent change.

**Impact:** This is considered a significant boon for business in the United States, bringing U.S. corporate tax policy more in line with (or even more favorable than) the corporate tax rates of other nations.<sup>3</sup> Interestingly, the new rate has also benefited some individuals, as a number of corporations gave employees a bonus as a result of the lower tax rate.<sup>4</sup>

#### Pass-Through Taxation

Owners of pass-through entities (sole proprietorships, S corporations, limited liability companies (LLCs) or partnerships) pay taxes on business income at their own individual income tax rate.<sup>5</sup> In order to keep pass-throughs in roughly the same relative tax position as C corporations, the TCJA created a new deduction for owners of certain pass-through entities—a deduction of 20% of the owner's share of qualified business income on their individual tax return, whether they itemize or not.<sup>6</sup> This deduction may be limited based on the W-2 wages paid by the business.<sup>7</sup>

The TCJA identifies a number of “specified service trades or businesses” that do not qualify for pass-through taxation.<sup>8</sup> A specified service trade or business is any trade or business:

- that involves the performance of services in the fields of accounting, actuarial science, athletics, brokerage

services, consulting, financial services, health, law, or the performing arts

- that involves the performance of services consisting of investing and investment management, trading, or dealing in securities, partnership interests, or commodities; or
- whose principal asset is the reputation or skill of one or more of its employees or owners.<sup>9</sup>

**Impact:** The pass-through entity deduction includes a number of complexities, along with gray areas that the IRS still needs to clarify. Owners of pass-through entities should thoroughly review their personal situations with a tax professional to determine if and how this change will impact their taxes.

## How Individual Taxes Have Changed

### Tax Rates

One of the TCJA's most important changes for individual taxpayers involves individual income tax brackets. While the number of brackets remained the same, the rates were lowered and the brackets were expanded.<sup>10</sup> These changes are effective for tax years 2018 – 2025.

The TCJA did not change the tax rate applied to capital gains and dividends; however, the tax brackets no longer match the individual income tax brackets.<sup>11</sup> For example, the top capital gains rate of 20% no longer lines up with the top income tax bracket, but instead has its own threshold that falls in the middle of the 35% bracket.

The net investment income tax remains in place. It has always used threshold amounts (AGI of \$200,000 for individuals and \$250,000 for married couples filing jointly) that are independent of the individual income tax brackets, and that does not change with the TCJA.<sup>12</sup>

**Impact:** The lower, wider tax brackets should provide a tax reduction for most taxpayers. The new tax brackets also significantly address the so-called “marriage penalty” by making all of the married filing jointly brackets except the top 37% bracket exactly double the single brackets.

### Exemptions and Deductions

The changes to deductions and the corresponding elimination of the personal exemption may impact certain taxpayers as much as the tax rate changes. These changes are effective for tax years 2018 – 2025.

### Pease Limitation on Itemized Deductions

The TCJA did provide good news to certain high-income taxpayers—a repeal of the Pease limitation, which was a phaseout of itemized deductions applied to indi-

viduals whose adjusted gross income exceeded \$261,500 in 2017 (\$313,800 for married couples).<sup>13</sup>

### Exemptions

Previously, each taxpayer was allowed to claim a personal exemption for themselves along with an exemption for each dependent (\$4,050 per exemption for 2017).<sup>14</sup> The TCJA effectively repeals these exemptions by setting the amount at zero.<sup>15</sup>

**Impact:** For the majority of taxpayers, the loss of the personal and dependent exemptions is offset (or more than offset) by the significant increase in the standard deduction. However, because there are a number of variables in play, not everyone—particularly those who claimed a high number of exemptions—will see tax savings.

### Deductions

While the TCJA eliminated the exemption, it increased the basic standard deduction to:

- \$12,000 for individuals (up from \$6,350)
- \$18,000 for head of households (up from \$9,350)
- \$24,000 for married couples filing jointly (up from \$12,700)<sup>16</sup>

These deduction amounts will be indexed for inflation.<sup>17</sup>

**Impact:** This significant change in the standard deduction will mean many more taxpayers will take the standard deduction instead of itemizing deductions on their federal income tax returns.<sup>18</sup>

### Charitable Deductions

While the TCJA did not change the charitable deduction, far fewer people will use it going forward—at least while the higher standard deduction remains in place. Individuals will continue to give for all the same reasons. However, donors who previously itemized and took the charitable deduction will now most likely find that the increased standard deduction provides a greater tax benefit—in essence, the charitable deduction is built in.

**Impact:** A taxpayer whose income tax situation places them near the decision point of standard deduction or itemized deductions, or who has significantly larger itemized deductions in a particular year (for example, extensive deductible medical bills), may wish to “bunch” their charitable donations into the year in which they would benefit most from the itemized deduction. Using this planning technique would allow the taxpayer to take the standard deduction during some years, then itemize deductions in other years when they “bunch” charitable donations to claim their most valuable deduction.

## SALT and Mortgage Interest Deductions

Two of the most controversial provisions of the TCJA are the changes to the state and local tax (SALT) deduction and the mortgage interest deduction. At times during the negotiations over the bill, media reports claimed that either or both deductions were going to be eliminated. The final bill kept them both, but with changes.

In 2017 and prior years, taxpayers were allowed to deduct from federal income taxes the full amount of state and local taxes paid (property taxes plus state income or sales taxes).<sup>19</sup> The final TCJA bill kept the state and local deduction but capped it at \$10,000.<sup>20</sup>

The 2017 IRC permitted taxpayers to take a mortgage interest deduction for the interest on a mortgage or a debt up to \$1,000,000.<sup>21</sup> The TCJA kept this deduction but lowered the cap to \$750,000 for mortgages entered into after December 14, 2017 (existing mortgages retain the higher cap, even if refinanced). The TCJA eliminated the mortgage interest deduction for home equity loans.<sup>22</sup>

**Impact:** These changes significantly impact taxpayers in states with high state tax rates. Many taxpayers in these states rushed to pre-pay 2018 property taxes during 2017 (since only pre-paying of state and local income taxes was specifically prohibited).

## How the Alternative Minimum Tax Has Changed

### Corporate AMT

Heralded as a key provision to improve the corporate tax environment, Congress repealed the corporate AMT beginning in 2018.

### Individual AMT

The individual AMT was not repealed, but it was revised to benefit taxpayers. For tax years 2018 – 2025, the TCJA increases the AMT exemption amount to \$109,400 for married taxpayers filing a joint return (half this amount for married taxpayers filing a separate return) and \$70,300 for all other taxpayers (other than estates and trusts).<sup>23</sup> The law also increases the phaseout thresholds to \$1,000,000 for married taxpayers filing a joint return and \$500,000 for all other taxpayers (other than estates and trusts). These amounts are indexed for inflation.

**Impact:** According to reports, members of Congress were concerned that the corporate AMT would create problems for corporations involved in research and development.<sup>24</sup> The repeal of the AMT should have a positive impact on these businesses in particular. In addition,

the revised individual AMT means a much smaller number of taxpayers will be affected during 2018 – 2025.

## It's a Wrap

The TCJA contains the most substantial changes to the U.S. tax system since 1986. While wealthy individuals and corporations are the clear winners, the vast majority of Americans will pay less in taxes. And even though most major deductions are retained, millions of households will now find that itemizing is no longer worthwhile thanks to the higher standard deduction. Changes like these can be viewed as a problem, an opportunity, or some combination of the two. No matter what approach you and your clients decide to pursue, the changes should not be viewed passively, since they are certain to impact planning in the future.

## ENDNOTES

- 1 Michael Hunt, "Why the Cassette Tape Is Still Not Dead," *Rolling Stone*, April 18, 2016.
- 2 26 U.S.C. §11.
- 3 "The United States' Corporate Income Tax Rate Is Now More in Line with Those Levied by Other Major Nations," *Tax Tips and News*, J. Walter Michael & Associates, February 12, 2018, and Dan McLaughlin, "GOP Business Tax Cuts Force Other Countries to Compete," *National Review*, December 27, 2017.
- 4 Paul Bedard, "\$1,000 Employee Bonus Check Credits Trump Tax Cuts and Jobs Act," *Washington Examiner*, January 15, 2018.
- 5 26 U.S.C. §701.
- 6 26 U.S.C. 199a.
- 7 26 U.S.C. 199a(b)(2).
- 8 26 U.S.C. 199a(d)(2).
- 9 Id.
- 10 26 U.S.C. 1(j).
- 11 26 U.S.C. §1.
- 12 26 U.S.C. §1411.
- 13 26 U.S.C. §68.
- 14 26 U.S.C. §151.
- 15 26 U.S.C. §151(d)(5).
- 16 26 U.S.C. §63(c)(7)(a).
- 17 26 U.S.C. §63(c)(7)(b).
- 18 26 U.S.C. §63(b).
- 19 26 U.S.C. §164.
- 20 26 U.S.C. §164(b)(6).
- 21 26 U.S.C. §163.
- 22 26 U.S.C. §163(h)(3)(F).
- 23 26 U.S.C. §55.
- 24 "SALT, AMT, Among Differences Awaiting Tax Bill Conference," CCH Tax Group, December 5, 2017.

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