THE CATHOLIC FOUNDATION

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

In This Issue:

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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.[1] Then came the introduction of compact discs—the first nail in the coffin of the cassette industry.

While other companies shifted to CDs, Steve Stepp recognized the ongoing demand for cassettes, broadening 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 businesses.

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.

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.[2] 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.[3] 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.[4]

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.[5] 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.[6] This deduction may be limited based on the W-2 wages paid by the business.[7]

The TCJA identifies a number of "specified service trades or businesses" that do not qualify for pass-through taxation.[8] 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.[9]

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.[10] 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.[11] 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.[12]

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.

Chained CPI for Inflation-Adjusted Numbers

Beginning in 2019, inflation adjustments will be based on the Chained Consumer Price Index for All Urban Consumers.[13] The "chained CPI" is a measurement of consumer prices prepared by the Bureau of Labor Statistics that takes into account the substitutions consumers make in the face of rising prices.[14] As a result, chained CPI shows a slower pace of price gains, or inflation, than traditional CPI. The proponents of chained CPI believe that it is a more accurate measurement of inflation, while critics argue that it may underestimate the cost of living in certain groups.[15]

Impact: Annual inflation adjustments to everything from tax bracket income levels to Social Security benefits will generally be smaller using this index.

Exemptions and Deductions

The TCJA 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.

Why 2018 -2025?

Reconciliation, of course, is the process by which the House and Senate work out differences between the bill drafts passed by each chamber. In order to comply with the Senate Byrd Rule, the bill included a "sunset" provision, which causes the section to self-repeal after 2025. However, that does not mean that these tax changes will go away after 2025. As the sunset date approaches, Congress can—and probably will—pass an extension or make the changes permanent.

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 individuals whose adjusted gross income exceeded $261,500 in 2017 ($313,800 for married couples).[16]

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).[17] The TCJA effectively repeals these exemptions by setting the amount at zero.[18]

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 and in the child tax credit amount. However, because there are a number of variables at 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)[19]

These deduction amounts will be indexed for inflation.[20]

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.[21]

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 most benefit from the itemized deduction. Using this planning technique would allow the taxpayer to take the standard deduction in 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.

Under the IRC, 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).[22] The final TCJA bill kept the state and local deduction but capped it at $10,000.[23]

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.[24] 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.[25]

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).

Litigation Note: TCJA SALT Limitation and High-Tax States

Although a suit is not yet filed (as of March 2018), a number of high-tax states have indicated that they will be suing the U.S. government based on the TCJA changes to the deductions allowed for state and local taxes.[26] This is one of the most damaging changes facing taxpayers in high-tax states like California, New York, New Jersey, Maryland and Connecticut.

According to the Hartford Courant, New York governor Andrew Cuomo, Connecticut Governor Dannel Malloy, and New Jersey Governor Phil Murphy are leading an effort to bring a federal lawsuit charging that these provisions of the TCJA are unfair to the residents of their states. The Washington Times notes that Maryland is bringing a similar challenge and quotes the Maryland Attorney General Brian Frosh as stating that the limit on the SALT deductions "is an attack on state sovereignty and an attempt to cripple our ability to educate our kids, protect the Chesapeake Bay, and build the infrastructure that Maryland needs to be competitive in the world economy."

If these challenges are filed, it will be worth noting the basis for the suit along with the remedy the plaintiffs intend to seek.

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).[27] 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.[28] 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.

How Estate and Gift Taxation Has Changed

The end of the federal estate and gift tax has long been a subject of political debate. During the lead-up to the passage of the Tax Cuts and Jobs Act, the prospect of Congress finally doing away with some or all of these taxes was being discussed once again.

The Bill in the Respective Houses

The original U.S. House of Representatives version of the bill took a two-part approach to eliminating the estate tax:

- Double the estate and gift tax exemption after December 31, 2017
- Eliminate the estate tax and generation skipping transfer tax completely after December 31, 2024 and reduce the top marginal gift tax to 35% for gifts made after December 31, 2024.

The Senate version of the bill kept the provision that doubled the estate and gift tax exemption after December 31, 2017, but included a sunset date of December 31, 2025. However, the Senate version of the bill did not eventually eliminate the tax as the House version did.

Current Law

As we know, the final version used the Senate language. The TCJA doubled the base exemption amount from $5 million to $10 million, with the inflation-indexed amounts rising from $5,600,000 to $11,180,000. Most other estate tax items remained the same:

- **Spousal portability did not change.** This is still an exceedingly strong planning tool, allowing a married couple to fully use the combined spousal amount of $22,360,000 (for 2018).
- **Basis step-up at death did not change.** An estate may still obtain a step-up in basis to the fair market value of all assets on the date of death.
- **Annual exclusion did not change.** The gift tax annual exclusion was not impacted by the TCJA and is still available ($15,000 in 2018).
- **Estate, gift and GSTT rates did not change.** The rates remain the same as prior to the new law.

Impact: With the much higher exemption amounts, most estates will not be subject to the estate tax. However, that does not mean that the TCJA does not have any impact on estates that fall under the new exemption amount.

For example, if a client uses a spousal trust and a bypass trust as part of an estate plan, it is possible that the higher exemption amount will impact the funding of these trusts (assuming funding is determined by a formula). In a typical trust arrangement, the client would fund the bypass trust with the deceased spouse's exemption amount and the remainder of the estate would go to the spousal trust. With the much higher exemption amount, this funding formula in an existing estate plan could lead to fewer assets (or even no assets) going into the spousal trust. In a worst-case scenario, a deceased spouse with an $11,000,000 estate could have the entire amount go to the bypass trust with nothing left to transfer into the spousal trust.

High-net-worth clients, in particular, should review their estate plans to ensure they are maximizing their use of the new exemption amounts and to verify that all existing formulas and calculations remain valid.

The Impact on the Affordable Care Act

Almost immediately after the Obama administration was successful in getting Congress to pass the Affordable Care Act (ACA) in 2010, the law was challenged in court. The defining case was likely the case of *National Federation of Independent Businesses vs. Sebelius, Secretary of Health and Human Services (NFIB)*.[29]

In NFIB, the plaintiffs, consisting of twenty-six states, several individuals, and the National Federation of Independent Businesses, challenged the constitutionality of the ACA. The plaintiffs argued that in passing the ACA, Congress exceeded its powers under Article I of the U.S. Constitution.[30] The key points of the claims were that:

1. The Commerce Clause did not support the individual mandate of the ACA (as found at 26 U.S.C. 5000A), and Congress's power to tax did not support the mandate.
2. If the individual mandate is unconstitutional, the Court must enjoin the entire ACA because it is non-severable.[31]

A divided Court held 5-4 that the individual mandate was Constitutional, but used an interesting rationale to reach that verdict, with Chief Justice John Roberts siding with both the majority opinion and with those who dissented. The Dissent (and the Chief Justice) found that the individual mandate exceeded Congress's power under the Commerce Clause and the Necessary and Proper Clause.[32] However, Chief Justice Roberts also agreed with the majority when he stated that it was "fairly possible" to read the individual mandate as a tax provision, and therefore it would fall under Congress' power to tax:[33]

> Under the mandate, if an individual does not maintain health insurance, the only consequence is that he must make an additional payment to the IRS when he pays his taxes. See §5000A(b). That, according to the Government, means the mandate can be regarded as establishing a condition—not

> owning health insurance—that triggers a tax—the required payment to the IRS. Under that theory, the mandate is not a legal command to buy insurance. Rather, it makes going without insurance just another thing the Government taxes, like buying gasoline or earning income. And if the mandate is in effect just a tax hike on certain taxpayers who do not have health insurance, it may be within Congress's constitutional power to tax.[34]

The Obama administration welcomed this reading of the law by the Court and the Affordable Care Act continued as the law of the land into the Trump administration. However, Congress included a provision in the TCJA that repealed the penalty provision of the ACA. This left only the mandate that the individual citizen must buy insurance. Needless to say, this language caught the attention of many who opposed the ACA.

As a result, on February 26, 2018, twenty states joined in litigation against the U.S., challenging the provisions of the ACA in the U.S. District Court for the Northern District of Texas. This challenge goes after the entire ACA based on the repeal of the penalty provision of the individual mandate. Their *Complaint for Declaratory and Injunctive Relief* states:

> Pursuant to the Tax Cuts and Jobs Act of 2017, starting in 2019, the tax penalty is eliminated by reducing the tax to zero. Pub. L. No. 115-97, § 11081, 131 Stat. 2054. The individual mandate itself, however, remains. But because the tax penalty provision in the ACA no longer raises any revenue, the Supreme Court's avoidance reading is no longer possible. As the Congressional Budget Office explained, the Tax Cuts and Jobs Act of 2017 "eliminate[s]" the "individual mandate penalty . . . but [not] the mandate itself."[35]

The states argue:

> The Patient Protection and Affordable Care Act (the "Affordable Care Act," "the ACA" or "the Act"), as recently amended, forces an unconstitutional and irrational regime onto the States and their citizens. Because this recent amendment renders legally impossible the Supreme Court's prior savings construction of the Affordable Care Act's core provision—the individual mandate—the Court should hold that the ACA is unlawful and enjoin its operation.[36]

The states made it clear that the intent of the case is to end the ACA, arguing that if the individual mandate requires the penalty to remain constitutional, now that the penalty (or the "tax" as the Roberts' Court determined it to be) has been removed, the individual mandate cannot stand on its own. The states argue:

> Once the heart of the ACA—the individual mandate—is declared unconstitutional, the remainder of the ACA must also fall. *NFIB*, 567 U.S. at 691–708 (Dissenting Op.). As Congress made clear, "[t]he requirement [for individuals to buy health insurance] is *essential* to creating effective health insurance markets." 42 U.S.C. §18091(2)(I) (emphasis added). "[T]he absence of th[is] requirement would undercut Federal regulation of the health insurance market." *Id.* §18091(2)(H). In particular, "the guaranteed issue and community rating requirements *would not work* without the coverage requirement [i.e., Section 5000A]." *King v. Burwell*, 135 S. Ct. 2480, 2487 (2015) (emphasis added). So because the remainder of the ACA does not "function in a *manner* consistent with the intent of Congress," the whole Act must fall with the mandate. *Alaska Airlines, Inc. v. Brock*, 480 U.S. 678, 684–85 (1987) (describing severability analysis) (emphasis added).[37]

As of March 2018, the U.S. had not yet responded to the complaint. It will be interesting to see what approach the administration takes to defend (or not defend) a law that President Trump, as a candidate, campaigned to overturn.

Planning for Change

Walt Disney loved Disneyland, with one important exception—the surrounding neighborhood reduced the immersive "magical" environment he had set out to create. Instead of waiting for changes around the Anaheim property, Walt and his brother, Roy, began planning. They reviewed possible sites for a new park and settled on the "sleepy" cow-town of Orlando, Florida.[38] Understanding the nature of speculation, they acted promptly and used holding companies to purchase land while keeping the company's interest in Orlando a secret.[39] This allowed them to purchase many thousands of acres of land (approximately 43 square miles) at around $10 per acre.[40] Once the project was publicly announced, the land jumped to $1,000 per acre.

A thorough analysis along with careful planning allowed Disney to buy not only enough land for the park, but enough land to create a "buffer zone" around the park to ensure that guests could completely escape the world around them. If Walt had waited passively, his preferred site may have been unavailable or the cost may have been many times more expensive.

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 the same or not as much in taxes. And even though most major deductions are retained, millions of households will now find that itemizing is no longer necessary thanks to the higher standard deductions. 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

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