INCOME TAX PLANNING FOR INDIVIDUALS, TRUSTS AND ESTATES: EFFECTS OF THE TAX CUTS AND JOBS ACT (TCJA)*

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*Officially: H.R. 1 – An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.

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DISCLAIMER

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SOME GENERAL GUIDANCE

- Unless otherwise excepted, TCJA provisions affecting individuals are effective January 1, 2018 and expire (“sunset”) at the end of 2025. Some exceptions are shown in this presentation.
- Unless otherwise excepted, TCJA provisions affecting corporations are effective January 1, 2018 and are permanent. Some exceptions are shown in this presentation.
- Special rules may apply to non-calendar year taxpayers.
- Generally, married filing separate return limitations and benefits are one-half of married filing jointly limitations stated herein.
- We cover many, but not all, changes in the TCJA that affect individuals.
- This presentation is current through September 23, 2018.

OUTLINE OF PRESENTATION

- We will review primarily the major TCJA tax changes affecting individual income taxation.
- We will point out income tax provisions of the TCJA that significantly affect trusts and estates.
- We will highlight several individual income taxation planning opportunities and needs.
- We will present some case studies of individual taxation, generally comparing tax burdens in 2017 versus tax burdens in 2018.

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PLANNING – IT'S COMPLICATED

- As mentioned previously, most of the individual changes are temporary.
- In most cases, individual tax changes sunset at the end of 2025 and are scheduled to revert to the law before the TCJA enactment.
- Will the changes really sunset? Will the changes be made permanent?
- How do we plan when lacking guidance from the Treasury on many fronts?
- Will one or more of the three bills comprising Tax Reform 2.0 be enacted into law?
- Would changes in Congress or a new president hasten or delay changes?
- While planning always involves uncertainties, these unknowns are magnified in these times.

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INDIVIDUAL TAX RATES

- Seven tax brackets: 10%, 12%, 22%, 24%, 32%, 35% and 37%
- Thresholds are adjusted
- The tax brackets are wider. For example, a married couple filing jointly reached the top tax bracket of 39.6% at $470,001 of taxable income. In 2018, the couple reaches the top MFJ tax bracket of 37% at $600,001 of taxable income.

NONGRANTOR TRUSTS AND ESTATES TAX RATES

- Four tax rates – 10%, 24%, 35% and 37%
- Top tax rates are still reached at $12,700 taxable income in 2018 (as scheduled before the TCJA).

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KIDDIE TAX

- Children that are subject to the “Kiddie Tax” will have two different tax regimes for their earned and unearned income:
  1. Earned Income: Taxed at the rates applied to single filers.
  2. Unearned Income: Taxed at ordinary income and preferential rates applied to trusts and estates.
- Children will no longer be subject to their parents’ tax rate.

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ABOVE-THE-LINE DEDUCTIONS

- Moving Expenses – Suspended through tax year 2025; however, still available for members of the U.S. military who move pursuant to a military order.
- Alimony – Effective for divorce or separation agreements entered into after December 31, 2018*:
  - Deduction – The deduction for alimony or separate maintenance payments is repealed.
  - Inclusion – The inclusion of income by the recipient is repealed.
  - Existing alimony or separate maintenance agreements are grandfathered, as are modifications to existing agreements.
  - This is a permanent change. No sunset.
  - Also applies to divorce or separation agreements existing before January 1, 2019 and modified on or after January 1, 2019, if the modification expressly provides that the amendments by the TCJA apply to such modification.
  - Planning: *Divorces are time-sensitive in 2018.*
  - Planning*: Back-door deduction of alimony.*

*Please note the 1-year delay on the implementation of this provision

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STANDARD DEDUCTION AND PERSONAL EXEMPTIONS

- The standard deduction is nearly doubled to the following amounts:
  - Married Filing Jointly: $24,000
  - Head-of-Household: $18,000
  - All Other Taxpayers: $12,000
    - The deduction is indexed for inflation in future years.
- The personal exemption is suspended through tax year 2025.
  - The personal exemption for estates and trusts remains at $100 (complex), $300 (simple), $600 (estates).
  - Planning: In many divorce cases, continue to address dependency deductions – remember the sunset.

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ITEMIZED DEDUCTIONS

- Medical Expenses – The AGI threshold is lowered to 7.5 percent for all taxpayers for tax years 2017 and 2018 and returns to 10 percent in 2019.
- Mortgage Interest – Taxpayers are permitted to deduct the interest paid on acquisition indebtedness of up to $750,000.
  - Debt incurred on or before December 15, 2017, is grandfathered under the previous law of interest paid on acquisition indebtedness of up to $1,000,000.
- Home Equity Interest – The deduction for interest paid on home equity indebtedness is suspended.

ITEMIZED DEDUCTIONS, CONTINUED

- State and Local Taxes – Taxpayers are permitted a maximum $10,000 deduction of the sum of:
  - (i) state and local real property taxes,
  - (ii) state and local personal property taxes, and
  - (iii) state and local income taxes (or sales tax, if elected).
  - This limitation does not apply to real property taxes and personal property taxes paid or accrued in carrying on a trade or business.
  - Nonbusiness foreign property taxes are no longer deductible.
- Many states are trying to engineer around the Federal SALT deduction limit. Will they succeed? We'll see. The IRS has made clear that it thinks not.

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ITEMIZED DEDUCTIONS, CONTINUED

- Charitable Contributions – Three modifications:
  1. Cash contributions to public charities now have a 60 percent of AGI limitation (previously it was 50 percent).
  2. Denial of charitable deduction for payments made in exchange for athletic seating rights (previously able to deduct 80 percent of amounts paid).
  3. Removal of substantiation exception for certain contributions reported by the charitable organization.
  4. HOWEVER, the 60 percent limit appears to revert to 50 percent, if contributions for the year are not entirely of cash to public charities.
  - Planning: *Qualified Charitable Distributions – see case later in the presentation*.
- Casualty Losses – Suspended through tax year 2025, unless the loss is attributable to a Federally declared disaster loss.
  - If a taxpayer has a personal casualty gain, he/she may deduct personal casualty losses not attributable to a Federal declared disaster loss in the amount equal to no more than the personal casualty gain.
- Wagering Transactions – In addition to the limitation on gambling losses, expenses incurred in carrying on any wagering transaction are also limited to the extent of gambling winnings.

ITEMIZED DEDUCTIONS, CONTINUED

- Miscellaneous Itemized Deductions Subject to 2-percent floor – These have been suspended and include investment fees and expenses, tax preparation fees, and unreimbursed business expenses, among others.
  - The IRS issued Notice 2018-61 in July 2018 that says the Section 67(g) suspension of the deduction of miscellaneous itemized deductions does not affect the deduction by estates and nongrantor trusts of “if not for” expenses described in Section 67(b) and Section 67(e).
- “Pease” Limitation – Suspends the overall limitation on itemized deductions.
- Planning: *Bunching – See case later in the presentation*.

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CHILD CREDIT AND DEPENDENT CREDIT

- Increases the child tax credit to $2,000 per qualifying child; $1,400 per qualifying child refundable – indexed for inflation.
  - Requires SSN for each qualifying child.
- Provides a $500 nonrefundable credit for dependents other than qualifying children (generally retaining the current law definition of dependent).
- Phase-out threshold of $400,000 (for married taxpayers filing a joint return), and $200,000 (for all other taxpayers).
- *See related case study later in the presentation.*

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RECHARACTERIZATION OF ROTH CONVERSION REPEALED

- Before the TCJA, a special rule allowed, among other actions, a conversion of a traditional IRA to a Roth IRA to be “unwound” in the following year anytime before a taxpayer must file his/her tax return.
- Now, the special recharacterization rule does not apply to a conversion of a traditional IRA to a Roth IRA. Thus, a recharacterization cannot be used to unwind a Roth conversion. However, recharacterization is still permitted with respect to other contributions.

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ALTERNATIVE MINIMUM TAX (AMT)

- The individual AMT has been retained.
- The exemption amounts have been increased to the following thresholds:
  - Joint Filers: $109,400 ($54,700 for MFS)
  - All other Filers: $70,300
- The exemption phase-out thresholds are increased to:
  - Joint Filers: $1,000,000
  - All other Filers: $500,000
  - Trusts and Estates – Remains unchanged.
- Many of the tax preference items that are AMT addbacks have been suspended.

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ACA SHARED RESPONSIBILITY PAYMENTS

- There are no individual shared responsibility payments beginning in 2019. The TCJA reduces the penalty for the individual mandate to $0.
- This repeal is permanent.
- The employer shared responsibility penalties and information reporting obligations remain in effect.

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PLAN LOAN OFFSETS

- Plan loan offsets
  - For participants who terminate with outstanding loans, loan is offset by reducing vested account balance
  - Participant may defer taxation on loan by rolling over and contributing balance to IRA
  - Timeline for making rollover is extended from 60 days after the offset to the due date (including extension) of income tax return for year of offset

FRINGE BENEFITS

- Achievement awards
  - Clarifies cash & equivalents and non-tangible property (e.g., theatre tickets) awarded for long service/safety achievement are included in income
  - Length of service awards for bona fide public safety volunteers
    - Increases aggregate amount of length of services awards that may accrue and be deferred with respect to any year of service to $6,000
- Qualified moving expenses (employer-paid)
  - Suspends exclusion from gross income and deduction by employer, except for military
- Qualified bicycle commuting reimbursements
  - Suspends exclusion from gross income
- Qualified transportation fringe benefits
  - No employer deduction (except employer-provided transportation for safety)

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ENTERTAINMENT & MEALS EXPENSES

- Entertainment expenses
  - Subject to limited exceptions, no deduction for entertainment, amusement, or recreation activities, facilities or membership dues related to such activities.
  - Repeals the “directly-related-to” and “associated-with” exceptions to the deduction disallowance
- Meals expenses
  - No more 100% deductible meals for employees for the benefit of the employer; these expenses are subject to 50% limitation and not deductible after 2025.
  - While reasonable people are currently disagreeing with one another,
  - it appears that the kinds of business meals that were 50% deductible before TCJA are still deductible.
- Planning: *Change chart of accounts and procedures to track changed categories of these kinds of expenses – see also the next slide.*

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ENTERTAINMENT & MEALS EXPENSES, CONTINUED

- Exceptions to the repeal of entertainment and meals costs.
  - [De minimis] food and beverages for employees. (Note the 50% limitation above for food and beverages.)
  - Expenses treated as compensation. (100% deductible.)
  - Reimbursed expenses. (100% deductible.)
  - Expenses for recreational, social, or similar activities (including facilities therefor) primarily for the benefit of employees who are not "highly compensated employees." (100% deductible.) Food and beverage – 50% limitation.
  - Employee, stockholder, agents, or directors business meetings. (Note the 50% limitation above for food and beverages.)
  - Meetings of business leagues. (Note the 50% limitation above for food and beverages.)
  - Items available to public. (100% deductible.)
  - Expenses for entertainment sold to customers. (100% deductible.)
  - Expenses includable in income of persons who are not employees. (100% deductible.)

ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAXES

- Estate and Gift Taxes – Beginning in 2018, the exemption for estate and gift taxes is increased to $10,000,000 (and adjusted forward for inflation from 2011).
  - Inflation – There will be a roughly $11,000,000 estate and gift exemption starting in 2018.
- Generation-Skipping Transfer Tax – Beginning in 2018, the amount of the generation-skipping transfer tax exemption is increased to $10,000,000 (and adjusted forward for inflation from 2011).
  - Inflation – There will be a roughly $11,000,000 generation-skipping transfer tax exemption starting in 2018.
- These increases are set to expire on December 31, 2025, and the exemption amounts will return to the pre-tax reform amounts.
  - This makes the current planning techniques still relevant, even for estates that do not exceed the increased exemption amount
- However, because of the significantly higher exemptions, in many cases income tax planning may surpass estate planning in importance.

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§199A DEDUCTION OVERVIEW

- §199A is a new code section which established a potential deduction equal to 20% of Qualified Business Income (QBI) from –
  - Pass-through entities (Partnerships, S Corporations or Sole Proprietorships, Trusts, Estates)
  - Rental properties
  - REITs and
  - Qualified Cooperatives
- This deduction expires December 31, 2025, unless renewed.
- The allowable deduction is computed on a per-business activity basis.
- This deduction effectively reduces the top rate to 29.6% (80% of 37%) on the QBI.
- Section 199A is a "below the line" deduction.
- §199A deduction does not apply for 3.8% NIIT computation.
- The deduction is subject to limitations:
  - Wages & Capital
  - Specified Services
  - Taxable Income

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§199A DEDUCTION OVERVIEW

- Is the taxpayer engaged in an effectively connected US trade or business (other than providing services as an employee) with qualified business income?
- Is the business a Specified Service Trade or Business (SSTB)?
- Is the taxpayer's net taxable income above or below the taxable income threshold?
- Does the trade or business pay wages or have qualified property?

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§199A DEDUCTION OVERVIEW

Some Recent Guidance from Treasury in the form of Proposed Regulations (August 8, 2018).

- Trade or Business
- Specified Service Trade or Business (SSTB)
- Aggregation
- Crack & Pack
- Anti-abuse Rules for Trusts
- Qualified Business Income (QBI)
- Carryover Losses
- Relevant Passthrough Entity
- Qualified Wages
- PEOs
- Qualified Property

IF TAXABLE INCOME IS:

< $157,500 (O) or $ 315,000 (M)	$ 157,501 - $207,500 (O) $ 315,001 – $ 415,000 (M)	> $207,500 (O) or $ 415,000 (M)
• Deduction is 20% of pass-through income • No W-2 wage limitation • No Specified Service Trade or Business limitation	• Deduction is phased-out across this range • W-2 wage limitation applies • Specified Service Trade or Business *may* take the deduction	• W-2 wage limitation applies • Specified Service Trade or Business **cannot** take any deduction

For all of the above –
limited to 20% of the excess of Taxable Income over the sum of any Net Capital Gain

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ENTITY-LEVEL QUALIFIED BUSINESS INCOME DEDUCTION (QBI)

Is taxable income below the threshold?

- Yes → The deduction is 20% of Qualified Business Income. No limitations apply to QBI
- No → Is the income from a Specified Services Business?
  - Yes → Is taxable income above the upper limit of the threshold?
    - Yes → No QBI deduction is allowed
    - No → The 20% QBI deduction is subject to the phase-in of wage limitation for the allowable specified services totals
  - No → Is taxable income above the upper limit of the threshold?
    - Yes → The 20% QBI deduction is subject to the wage limitation
    - No → The 20% QBI deduction is subject to the phase-in of wage limitation

*The QBI deduction is limited to 20% of (Taxable Income – Capital Gains)

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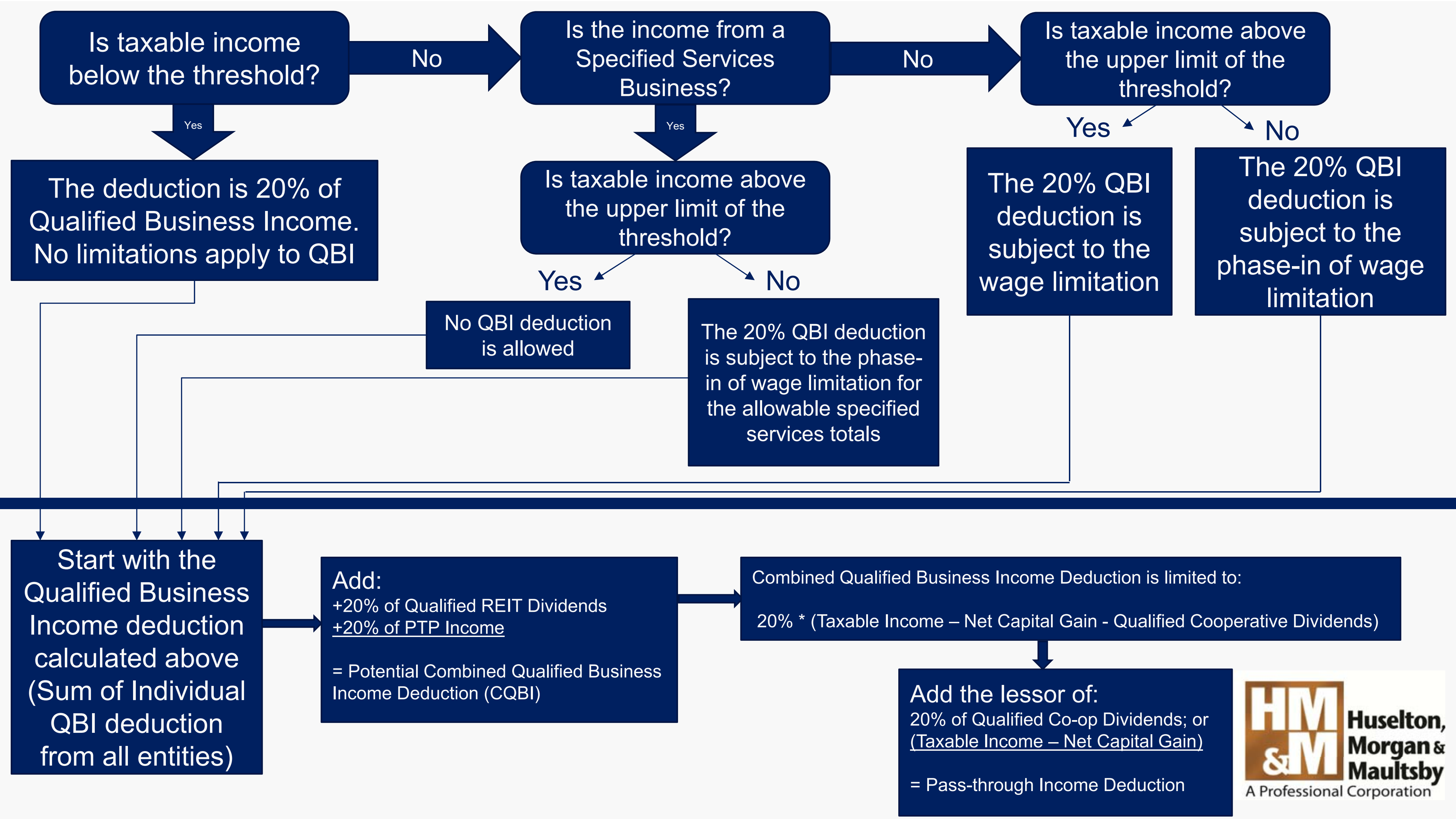
Is taxable income below the threshold?
No
Is the income from a Specified Services Business?
No
Is taxable income above the upper limit of the threshold?
Yes
The deduction is 20% of Qualified Business Income. No limitations apply to QBI
Yes
Is taxable income above the upper limit of the threshold?
Yes
No
No QBI deduction is allowed
The 20% QBI deduction is subject to the phase-in of wage limitation for the allowable specified services totals
Yes
The 20% QBI deduction is subject to the wage limitation
No
The 20% QBI deduction is subject to the phase-in of wage limitation
Start with the Qualified Business Income deduction calculated above (Sum of Individual QBI deduction from all entities)
Add:
+20% of Qualified REIT Dividends
+20% of PTP Income
= Potential Combined Qualified Business Income Deduction (CQBI)
Combined Qualified Business Income Deduction is limited to:
20% * (Taxable Income – Net Capital Gain - Qualified Cooperative Dividends)
Add the lessor of:
20% of Qualified Co-op Dividends; or
(Taxable Income – Net Capital Gain)
= Pass-through Income Deduction
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SOME OTHER PROVISIONS THAT AFFECT INDIVIDUALS (AND NOT COVERED IN THIS PRESENTATION)

Because I just ran out of time.

- Carried Interest Holding Period
- Excess Business Loss Limitation
- Net Operating Loss Limitation
- The Deductibility of Business Interest Limitation
- Section 1031 – Like-Kind Exchanges
- Depreciation and Expensing of Property
- International Provisions

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CHARITABLE GIVING

- Reduces incentives for charitable giving by:
  - Doubling the standard deduction
  - Doubling estate tax exemptions
  - Repealing the deduction for tickets to and seating rights for college athletic events
- Increases the incentives for charitable giving by:
  - Repealing the "Pease" limitation
  - Increasing the charitable contribution deduction limit

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CHANGE TO INFLATION ADJUSTMENTS

- Beginning in 2018, inflation adjustments throughout the Internal Revenue Code are based on the Chained Consumer Price Index, or Chained CPI.
- Generally, this will result in higher taxes over time compared to the previous inflation adjustment, the Consumer Price Index.

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OTHER MATTERS

- Modeling
- Review of entity selection and possible conversion
- Financial reporting implications, including accounting for income taxes
- State tax implications
- Accounting systems and charts of accounts
- Technical corrections
- Guidance continuing to be issued

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CASE STUDIES

- Frisco couple in their 30s with 3 kids
- Single and successful attorney in New York City
- “Upper middle income” couple, one is a CPA in Dallas
- Retired Lakewood couple, both over age 70 ½ years

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FRISCO COUPLE IN THEIR 30S WITH 3 KIDS

In 2017,

- Bob is an engineer and has W-2 income of $160,000.
- Ann is a full-time homemaker, mother and chauffeur for their three kids ages 6, 8, and 10.
- In 2017 they had the following itemized deductions
  - Real estate taxes - $7,000
  - Mortgage interest - $14,000
  - Charitable contributions - $2,000
- 2017 Federal income tax - $19,645

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FRISCO COUPLE IN THEIR 30S WITH 3 KIDS, CONTINUED

Assume SALY for 2018

Federal taxes – $15,561. Down $4,084.

- What changed?
  - Lost $20,250 in personal exemptions, but gained $5,500 in child credits.
  - Tax brackets beneficial – top bracket declined from 25% to 22%; average tax rate declined from 17.57% to 15.98%.
  - Note: itemized both years (formula sales tax deduction added to SALT and moved itemized above $24,000 standard deduction.)

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SINGLE AND SUCCESSFUL ATTORNEY IN NEW YORK CITY

In 2017,

- An SMU law school grad making it big, Elizabeth is 38 years old, single, and a partner in a big New York law firm. Her share of partnership income on line 1 of her K-1 was $1,200,000.
  - She rents a high-rise apartment in Manhattan for $12,000 per month.
  - Her health insurance cost on her K-1 is $9,000. Other medical expenses total $6,500.
  - $145,000 New York state and city taxes paid.
  - Charitable contributions of $40,000, which includes $12,000 of contributions (80% deductible) that secure seating rights to SMU basketball games. (Her mom and dad use the seats most of the time.)
  - Federal income tax - $412,501.

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SINGLE AND SUCCESSFUL ATTORNEY IN NEW YORK CITY, CONTINUED

Assume SALY for 2018. Assume also that New York does not get away with its attempts to recharacterize its personal income tax as something deductible.

Federal taxes – $439,672. Up $27,171, a 6.6% increase in tax

- What changed?
  - Biggest change – $145,000 of SALT capped at $10,000.
  - 80% of $12,000 of payments no longer considered contributions.
  - Lower top tax brackets and wider brackets helped. Average tax rate dropped from 35.23% to 33.96%.

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UPPER MIDDLE INCOME COUPLE. ONE IS A CPA IN DALLAS

In 2017,

- Charlotte and Dan are married and in their mid-50s.
- Charlotte is a CPA sole proprietor in Dallas. She netted $315,000 from her practice. She has no employees. She reports her business income on Schedule C.
- Dan retired early. He claims to be a professional fisherman. He still is waiting for his first income from his fishing. Charlotte treats his fishing as a hobby on their tax return.
- No mortgage interest.
- Charitable contributions – $6,000.
- Property Taxes – $8,000.
- Ignore medical expenses and health insurance for this example.
- 2017 Federal taxes – $91,461.

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UPPER MIDDLE INCOME COUPLE. ONE IS A CPA IN DALLAS, CONTINUED

Assume SALY for 2018

Federal taxes – $75,094. Down $16,367.

- What changed?
  - Primarily Charlotte's $55,760 Section 199A deduction in 2018.
  - Standard deduction of $24,000 in 2018 compared to $17,016 itemized deductions in 2017.
  - Wider tax brackets and lower rates helped, too.

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RETIRED LAKEWOOD COUPLE, BOTH OVER AGE 70 ½ YEARS.

In 2017,

- Fred and Ellen are both over 70 ½ years of age
- Their retirement income is comprised of:
  - IRA distributions – $180,000
  - Social Security – $60,000
  - Interest Income – $5,000
- Property taxes – $12,000
- Charitable contributions – $25,000
- 2017 Federal taxes – $39,733

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RETIRED LAKEWOOD COUPLE, BOTH OVER AGE 70 ½ YEARS, CONTINUED

Assume SALY for 2018

Federal Income Tax – $36,819. Down $2,914.

- What changed?
  - Decline in tax caused primarily caused by lower rates and wider brackets.
  - Decline offset by SALT cap.
  - Decline offset by loss of personal exemptions.

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RETIRED LAKEWOOD COUPLE, BOTH OVER AGE 70 ½ YEARS, CONTINUED

- What if they bunched two years of contributions in 2018? Assume 2019 SALY.
- Bunching would reduce their taxes over the two-year period 2018 and 2019 by $4,152.
  - They itemize deductions in 2018 and use the standard deduction in 2019.
- Bunching can be done at any age.
- You might consider making the “advance contribution” to a donor-advised fund of a public charity.

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RETIRED LAKEWOOD COUPLE, BOTH OVER AGE 70 ½ YEARS, CONTINUED

- Generally, a qualified charitable distribution ("QCD") is an otherwise taxable distribution from an IRA owned by an individual who is 70 ½ or over that is paid directly from the IRA to a qualified charity. A QCD can satisfy all or part of your required minimum distribution from your IRA. The maximum QCD for any individual $100,000 per year. (Note that you cannot direct a QCD to a donor-advised fund of a public charity, a private foundation or a supporting organization.)
- What if they used QCDs from their IRAs to make the contributions without bunching?
- The couple would pay $3,984 less combined tax in 2018 and 2019, using the QCD strategy, rather than the bunching strategy. They are "deducting" all charitable contributions and getting the standard deduction in both years.
- The QCD strategy beats the base case by $8,136 for the two years.

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CONTACT INFORMATION

- If you have questions about the presentation or TCJA planning, contact Vance Maultsby.
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- Keep up with TCJA updates and presentations at
  - www.hmpc.com/tax-reform/

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