Tax Reform, Winners and Losers ©

The *Tax Cuts and Jobs Act* (TCJA) is an intricate set of new laws that have been introduced into the complex fabric of the Internal Revenue Code starting in 2018. The new law is the largest tax law revision since the Tax Reform Act of 1986 and will impact decisions on where we want to live, how to invest, what type of entity is best for holding assets and finally whether you should strive to be self-employed instead of working for someone else. There is hardly an aspect of our economy that will not be impacted, from international business, to local charities, decisions by state legislatures will be impacted as will the cost structure for medical insurance, and the funds held for investment by major universities will now be taxed.

Tax laws are founded on three principles, these include:

- Funding the Government – For Example: Balancing the federal budget
- Economic Stimulation - For Example: Business deductions for equipment purchases
- Societal Good - For Example: Tax credits for the cost of college

For the first time a unique regional element has been introduced as a principle of tax legislation. Residents of states with lower state income tax rates and lower home prices have a favored status over the residents of states with higher state income and property tax burdens, and home prices. This unusual circumstance is causing many states to do everything from sue the US government to divining complex new tax protocols. For example, allowing a tax credit against a “charitable donation" of your state income tax or placing a heavier burden on employer taxes rather than workers, as corporate state tax deductions have not been phased out.

Tax Rates:

Let's look first at the new tax rates. Tax rates have been reduced under the TCJA for corporations by 40%. Also the corporate AMT was repealed by the TCJA. This reduction is thought to be the main cause, about 85%, of the anticipated 1.5 trillion in new federal budget deficits. The reduction in the top marginal corporate tax rate from 35% to 21% has been discussed in some circles as leading to more hiring and economic growth. It is noteworthy that as the marginal tax rates are reduced, the tax benefit from adding additional costs decreases, as a result the after-tax cost of both hiring employees and purchasing equipment increases. Whether corporations choose to use the tax windfall to accelerate the economy, or for stock buybacks, the reduction of corporate debt and shareholder dividend payments, is the subject of arguments among economists. The outcome will become clearer to everyone over the next 12 to 24 months.

Individual rates are also cut back. The top bracket decreased from 39.6% to 37%. Marginal tax rates up the tax bracket scale are lower at each tax bracket break point, benefiting taxpayers at all income levels. The capital gains and dividend tax rates under are unchanged under TCJA. The Alternative Minimum Tax (AMT) will be less of a problem for many individual taxpayers under the TCJA. The AMT applies in situations where it produces a greater tax liability than the regular tax system. Evaluating AMT exposure is essentially an exercise in determining whether there are enough "add-backs", like state and local taxes (SALT) such that the tax due under the AMT system is more than your regular tax liability. Before the law change income exposed to the AMT was reduced by an exemption that phased-out at moderate income levels. Under the new law the exemption is increased and the phase out is muted. Also, the primary add-back for most taxpayers was SALT, which is now capped at $10,000 for regular tax. Accordingly, the SALT cap and increased AMT exemption will eliminate the impact on many of the AMT on many Americans.

Deductions:

Many deductions are impacted by the TCJA. The four biggies include: 1) the increase in the tax exemption for taxpayers that do not itemize their deductions to $24,000 for married individual filers (Note, exemption deductions for dependents are eliminated), 2) individual filers also lose certain itemized deductions (state and local taxes (SALT) are limited to $10,000 and the mortgage interest deduction is limited to interest on a maximum of $750,000 in mortgage principle (Note, the phase out of itemized deductions for higher income taxpayers is eliminated), and the employee business expense deduction has been eliminated), 3) A new business deduction allows for the immediate expensing of all equipment purchased by companies, and 4) There is a new deduction for pass-through entities based on 20% of income. This deduction is not tied to an out of pocket expenditure of funds; it is simply a reduction in taxable income for those that meet the requirements.

The pass-through deduction is available for proprietorships, Limited Liability Companies, landlords, partnerships, trusts, and special corporations called S corporations that pass through their tax attributes to their owners rather than pay tax on their own earnings. As employees will not qualify for the pass through deduction, starting a business to be self-employed provides an advantage over employees under the TCJA. The pass-through deduction may incentivize employees to continue doing the same job but as an independent contractor so that they can shelter their income with the pass-through deduction. As the TCJA takes away the tax deduction for employee business expenses (tax prep fees, business mileage and meals, etc.), forming a small business will allow a taxpayer to write-off business related expenses and gain access to the new pass-through deduction. The status of independent contractors versus employees is a hard fought battle for State and Federal payroll tax agencies; due to the significant exposure companies have for assessment of payroll tax and workers compensation, it may be time to brush up on the 20 factors used to determine the status of workers versus contractors.

Availability of the pass-through deduction is stratified by income level and industry. At higher levels of income there are limitations on the full 20% write-off. For example, a high income real estate enterprise with little payroll can use an asset limit to obtain benefits, while a company with large payroll can use a payroll limit. There is also a payroll and asset blend. At higher income levels certain professions are excluded from the benefit of the pass-through deduction, including: medicine, law, accounting and consulting (where the reputation of the consultant is a material reason for patronage). These business owners may be motivated to segregate different lines of business into multiple entities to segregate income streams in an effort to obtain the benefit of the deduction.

Alimony will no longer be a deduction under the TCJA. For more affluent taxpayers this will not be a significant issue as the deductibility of alimony is a factor in setting alimony. Alimony will be a challenge for the less well-off where the tax benefits of one party is a subsidy allowing for an enhanced amount of alimony for a low income spouse. Also, for existing divorce agreements modified after December 31, 2017 that specifically include a TCJA amendment in the modification, alimony can be made nontaxable to the recipient spouse and non-deductible for the payor spouse. The tax deduction for matters adjudicated prior to the TCJA are grandfathered in, however many existing prenuptial agreements may have to be reconsidered.

Winners and Losers under the *Tax Cuts and Jobs Act:*

The TCJA is a labyrinth of added complexity piled on top of an existing whirlpool of statute, IRS regulations and Tax Court decisions. That being said, below we present the Winners and Losers Table. This will help you get an idea of how you came out under the law.

We ran hypothetical scenarios through our spreadsheets and evaluated the outcomes for typical income profiles. Each individual scenario and planning opportunity requires a detailed analysis so the table is designed to only to point you in a direction for anticipating the impact of the law. The greater your income, or deductions, the more you should evaluate the consequences of this historical tax law revision on your own individual facts and circumstances. Other important provisions have changed that are not covered here, including like kind exchanges, moving expenses, Roth IRA conversions, business entertainment costs, Section 529 account distributions, and child tax credits.

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Green: Big Win
Light Green: Ahead of where you were in 2017
Yellow: Break Even, or a little ahead
Red: Behind of where you were in 2017

CATEGORY	EXPLANATION	THE IMPACT
Large Estates	The TCJA Doubles the Estate & Gift Exclusion to $11,200,000 per person. Gifts made prior to any reduction to the exclusion in future legislation cannot be clawed back.	Married Couples can transfer $22,400,000 (singles can transfer $11,200,000) free of Gift & Estate Tax through gifting and avoid a future tax on the transferred assets.
Taxable Corporations	Rate Reduction from 35% to 21%, immediate deduction for equipment purchases.	Large companies will have excess cash in 2018. We will soon see what shareholders want done with the excess cash.
High Earners with Pass Through Companies, not living in high tax states Note see (A)	A Tax Rate reduction and the pass through deduction from new Internal Rev. Code Section 199A.	Significant tax reduction.
High Earners No Pass Through or the wrong industry. See (A)	A Tax Rate reduction and out of the alternative minimum tax.	A noticeable reduction in their tax liability.
High Earners with Pass Through Companies, or dividends and capital gains, who are domiciled in high tax states Note see (A)	A Tax Rate reduction, pass through deduction, loss of the state tax deduction, possible mortgage interest limitation.	Beneficial reduction in taxes, probably out of the alternative minimum tax due to limited state tax write offs.
High Earners, who are domiciled in high tax states No Pass Through, or the wrong industry See (A)	A Tax Rate reduction, loss of the state tax deduction, possible mortgage interest limitation.	A reduction in their tax liability. Also out of the alternative minimum tax due to limited state tax write offs.
Medium Earners Low Tax State	A Tax Rate reduction.	Less Tax will be due.
Low Income	Lower Tax Rate and the new expanded exemption of $24,000.	Good Tax Saving for income between $10,000 and $30,000.
Medium Earners High Tax State	A Tax Rate reduction, loss of the state tax deduction, assume mortgage balance less than $750,000.	Possible reduction in tax liability. May be using the new $24,000 instead of itemizing deductions. Medical Insurance Premiums expected to rise 10%.
Low Income Divorcing Couples	Alimony not deductible.	Challenges in Settling Family Law Matters.
Universities	A New Tax On Endowment Funds.	Added College Costs.

Footnote (A) The deduction phases out at certain income levels for certain industries: accountants, lawyers, physicians, veterinarians, chiropractors, the performing arts, professional athletes, financial services, consultants if the trade or business involving the performance of services.