Income Tax Has Been Simplified Beyond All Understanding

The tax reform legislation that was signed into law on December 22, 2017 has left many of us wondering how exactly our taxes may change. Will it dramatically redistribute wealth? Will it affect where we send children and grandchildren to school? Will it affect whether or simply *where* we buy a home? Don't worry – Rockwood is here to help.

You have undoubtedly been bombarded with contradictory opinions – so we thought you might appreciate the clarity of a comprehensive overview of the key areas of change, as well as their potential effects on your taxes. Of course, our clients are a diverse group, but **we're taking time to highlight several areas that will broadly impact most of us**.

The central provision of the bill is a **lowering of the corporate tax rate to 21%**, though many provisions affect individual tax rates. Unlike changes to the corporate rate, all the individual tax changes will lapse after 2025. This "sunset" provision was necessary to meet the Byrd rule requirement that allows Senate legislation to be passed with a simple majority only if it doesn't result in net tax cuts beyond a 10-year period.

The seven marginal tax brackets remain, though most have been trimmed by a few points. The good news is that these changes will produce at least a **small reduction in marginal tax rate for nearly all taxpayers**. Every year, these brackets will be adjusted for inflation, using the chained CPI (rather than the traditional CPI current used). Many believe this is a more accurate representation of inflation, though it may lag previous methods for calculating inflation.

The standard federal deduction has essentially been doubled. Legislators want fewer people to itemize their taxes. To achieve this, they've nearly doubled the standard deduction. For single filers, the standard deduction has increased from $6,350 to $12,000; for married couples filing jointly, it's increased from $12,700 to $24,000. However, the personal exemption is eliminated. Previously, you could claim a $4,050 personal exemption for yourself, your spouse and each of your dependents (subject to income phase-outs), which lowered your taxable income. No longer. For some families, the elimination of the personal exemption will reduce or negate the tax relief they get from other parts of the reform package.

Further supporting the notion that **fewer families will be itemizing their deductions** is that **deductions for state and local income tax and property tax will be limited to $10,000 per return**. Clients in states with higher income and property taxes (such as New Jersey, Massachusetts, New York, California and Maryland) will feel a higher relative impact here.

Mortgage debt deductibility remains unchanged for current homeowners; however, the bill lowers the cap on mortgage debt eligible for deductions from $1 million to $750,000 and eliminates deductions for home equity debt (currently capped at $100,000), except if the homeowner uses the money for home improvements. The deduction for second homes survived the final bill, with the $750,000 cap applying in aggregate to mortgage debt.

Home equity debt that is *not* used for improving the home, but rather for other purposes such as paying for college, will not be deductible. While home equity remains an inexpensive source of liquidity due to low interest rates, these tax changes (which impact grandfathered HELOCs and home loans as well) will impact future determinations to borrow in such a manner.

The tax reform legislation has **repealed all miscellaneous itemized deductions** that had been subject to the 2%-of-AGI floor, which includes tax preparation and investment advisory fees. Rest assured that Rockwood has made the appropriate changes to ensure that our fees are thoughtfully deducted in a tax-efficient manner. This includes using pre-tax money for our advisory fees on IRAs. For example, a client in a 37% marginal tax bracket, with a $1,000 quarterly fee on an IRA account, will have the wealth advisory fee debited from that IRA rather than pay with $1,000 of after-tax dollars. The latter methodology would require $1,370 of earned dollars before the application of federal tax.

The range of expenses covered by 529 plans has expanded. **Notably, up to $10,000 can be distributed per student from a 529 plan for private and elementary school expenses**. Before, the use of 529 plans was limited to college expenses only, so this provides further flexibility for families using 529 plans to cover their children's education. Many states provide deductions for contributions to 529 plans – including Pennsylvania, which allows for a deduction of the annual gift exclusion limit of $15,000 per parent for each child's account, limited by each individual's income. We are big fans of 529 plans as a vehicle to save for college, given the tax-free growth on the funds provided they are ultimately used for education.

Alternative minimum tax (AMT) exposure is reduced. There had been talk of repealing the AMT altogether, which increases the tax burden on those with significant deductions, by disallowing some of them and thus calculating an alternate tax. Changes to the AMT exemption and phase-out thresholds, combined with fewer itemized deductions, a higher standard deduction and new lower income tax brackets, will dramatically reduce the number of people and amount of income subject to the AMT.

Estate and gift tax exemptions have doubled. Each person will now be able to leave up to a $11.2 million estate ($22.4 million for married couples) without incurring any federal estate tax. Under the prior law (where individuals were to have a $5.6 million estate exemption in 2018), fewer than 5,000 estates per year were impacted by federal taxes. With this doubling of the exemption, the number of families and estates impacted by any federal estate taxes will decrease further still.

There is an apparent **crackdown on deferred compensation** found in many executive compensation plans. Taxation will be triggered as soon as there is no substantial risk of forfeiture, such as when funds are vested, even if they are not paid out at that time. There will likely be many revisions made to deferred compensation plans in the coming year to ensure income is not taxed until receipt, as intended under the plans.

There are a few other areas to highlight, including the **repeal of the individual health insurance mandate**. Beginning in 2019, there will be no penalty for not holding health insurance for the duration of the year.

Additionally, **tax treatment for alimony is reversed for divorce agreements after December 31, 2018**. Right now, alimony payments are tax-free for the payer, and they are taxed like regular income for the recipient. Since the recipient usually makes less taxable income and, accordingly, is in a lower tax bracket, this application of the tax keeps more money in the family unit and away from Uncle Sam. However, starting in 2019, this will no

longer be the case – alimony will be considered taxable income to the individual paying. Eliminating the alimony tax deduction may also have unforeseen implications, complicating how child support is calculated and how assets are divvied up.

There are also changes to the ability to recharacterize Roth conversion – **the option of undoing a Roth conversion will be eliminated** for any transactions in 2018 and beyond. In some planning cases, it can make sense to convert funds in a traditional IRA to a Roth, taking advantage of disparate brackets over the years. The ability to undo the transactions and recharacterize part or all of the funds will no longer be an option.

Perhaps the most multifaceted and controversial aspect of the tax bill is the treatment of income from pass-through entities, which constitute 95% of businesses in our country. You may have heard of the **20% deduction for pass-through entities**, namely that pass-through businesses such as partnerships, LLCs, S corporations and sole proprietorships filing Schedule C will be taxed on only 80% of their pass-through income. There are several detailed provisions and clarifications regarding which businesses will benefit from this rule.

However, to limit the appeal of business owners reclassifying their wages as business income eligible for the pass-through rate (i.e., an owner/employee leaving their firm and then contracting back via a pass-through entity), the new bill puts a number of restrictions in place.

The application here is incredibly nuanced, and we encourage our business owner clients to discuss this collectively with us and your CPA. We are always happy to offer our thoughts on the matter and suggest considerations for structuring your business.

Your 2017 tax returns (with a regular filing date of April 18) will still be completed using the prior tax code – it is your 2018 taxes (through 2025) that will be impacted by the Tax Cuts and Jobs Act and its associated provisions.

Given the uniqueness of every client's circumstances, we look forward to discussing your personal opportunities and impacts as we continue to meet. While this bill does not deliver the wide simplification to our tax code that was intended, it represents the most substantive tax reform we have seen since the 2001 and 2003 Bush tax cuts.

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