KLS PROFESSIONAL ADVISORS GROUP, LLC

Complete Financial Management

REPUBLICANS PROMISE ECONOMIC GROWTH THROUGH NEW TAX LEGISLATION

The recently passed Tax Cuts and Jobs Act (the "Act") is the most sweeping change in tax law since 1986. The expectation of the President and Congress is that the Act will spur economic growth which will create greater economic opportunities for all Americans. The Act reforms the corporate, pass-through business, estate and gift and individual tax rules by lowering marginal tax rates, expanding the tax base and, in theory, simplifying the tax code.

The Act's most significant income tax rate change reduces the top corporate tax rate from 35% to 21%. The Act also doubles the amount of wealth now exempt from Federal estate and gift taxes. Small business owners and wealthy families with business income primarily earned through pass-through structures will benefit from the new law. Although simplification and a tax reduction were promised to individuals, it is likely that these benefits primarily will be reaped by taxpayers with income below the top marginal bracket. High earners, especially those living in high-tax States, may in fact experience an increase in their Federal income tax burden.

Unless otherwise noted, the following changes to the tax law will be in effect from January 1, 2018 through December 31, 2025. The law will sunset beginning January 1, 2026 without extension by a future tax act. The reversion to 2017 law exists to keep the cost of the Act below $1.5 trillion, a requirement of Congressional budget rules.

Below is a summary of the Act's provisions most pertinent to KLS clients.

INCOME

- The Act imposes the highest tax rate of 37% (reduced from 39.6% under 2017 law) on taxable income over $600,000 for married couples filing joint returns, and on taxable income over $500,000 for single individuals. Taxable income less than these amounts will be taxed at graduated rates under wider brackets than previously existed, implying less Federal tax owed. However, because many tax deductions have been eliminated or capped, taxable income and hence ultimate tax liability may actually increase.
- Long term capital gains and qualified dividends continue to be taxed at preferential rates. No FIFO rule was enacted regarding the ordering of selling high or low tax cost shares.
- The Affordable Care Act taxes, including the 3.8% tax on Net Investment Income and the 0.9% additional Medicare tax, have not been eliminated or changed.
- The Alternative Minimum Tax (AMT) remains. However, the effect of the AMT has been significantly reduced because the most common deduction which exposed taxpayers to the AMT (state and local taxes) has been greatly limited. It is unlikely that the new AMT will apply to most KLS clients.

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- For any divorce or separation agreement executed after December 31, 2018, alimony ceases to be taxable income to the recipient and is no longer deductible by the payor. This is a revenue-raising provision as the payor spouse typically is in a higher tax bracket than the recipient. This new provision makes alimony payments more expensive for the payor, so we anticipate future divorce settlements will require after-tax calculations. This provision is not scheduled to sunset on December 31, 2025.
- Non-corporate taxpayers conducting a trade or business including through a pass-through entity (S-corporations, LLCs and LLPs) may be eligible to deduct 20% of their Qualified Business Income from a Qualified Trade or Business, effectively reducing their top tax rate on qualified activities to 29.6% (80% of the new highest marginal tax rate). Qualified Business Income is net domestic trade or business income including passive income. A Qualified Trade or Business is any domestic trade or business except investing and investment management and the specified service trades or businesses of law, health, accounting, consulting, athletics, and financial and brokerage services. A participant in a specified service trade or business may be eligible for the deduction at low income thresholds. There is an overall limitation on the 20% deduction based on wages paid by the business and capital invested in the business. The pass-through provisions should most favorably impact small business owners and wealthy taxpayers who derive income from ownership of pass-through businesses. The Act notably applies to real estate activities, including passive investments in real estate. Investors with portfolio income (interest, dividends and capital gains) may not avail themselves of these rules by contributing investment portfolios to pass-through entities, but continue to benefit from the preferential rates on qualified dividends and long-term capital gains.

<u>DEDUCTIONS</u>

- The standard deduction is raised to $24,000 for joint filers and to $12,000 for all other individuals. Due to the elimination of many itemized deductions, the standard deduction has become relevant for many taxpayers who previously claimed itemized deductions.
    - New rules apply to the deduction of home mortgage interest. For mortgages acquired prior to 2018, interest continues to be deductible on mortgages up to $1,000,000. For mortgages acquired after 2017, a reduced limit of $750,000 applies (with a limited exception for purchase contracts entered into in late 2017). The deductibility of interest on up to $100,000 of home equity indebtedness is eliminated, even for pre-2018 lines of credit. The economic benefit of home equity lines may need to be revisited given recent increases in short-term interest rates coupled with this loss of tax deductibility.
    - Only $10,000 of state and local income taxes and/or property taxes will be deductible. The new tax law expressly denies a deduction for state and local income taxes paid in 2017 which relate to a year after 2017, and thus taxpayers who prepaid 2018 state and local income taxes will not be able to claim a deduction when they file their 2017 Federal tax return. While the Act did not address prepayment of property taxes, the IRS has announced that a deduction for 2018 property taxes will be denied if the taxes were not yet assessed.

- The deduction for charitable gifts remains. The limit on deductible cash gifts to public charities has been increased from 50% to 60% of Adjusted Gross Income.
- The medical expense deduction will be allowed for expenses which exceed 7.5% of Adjusted Gross Income for individuals age 65 and older. In 2017, medical expenses exceeding 7.5% of Adjusted Gross Income will be deductible for all taxpayers without regard to age. Prior to this retroactive change, the threshold for deductibility for taxpayers younger than age 65 was 10%.
- Miscellaneous itemized deductions subject to the 2% Adjusted Gross Income floor are repealed. These include investment management fees, tax preparation fees, safe deposit box fees, dues to professional organizations and unreimbursed employee expenses. For high income taxpayers the 2% hurdle was rarely exceeded, meaning this change in law has little impact.
- The Pease adjustment, which previously limited itemized deductions for high income taxpayers, is eliminated.
- The child tax credit is increased to $2,000 and begins to phase out for married couples with income exceeding $400,000.

- Personal exemptions are repealed. Under 2017 law the personal exemption was phased out for high income taxpayers, so the repeal of the personal exemption may not have an impact on many KLS clients.

Due to the elimination of many itemized deductions, it is possible that the standard deduction may now exceed a taxpayer's itemized deductions. Married taxpayers whose itemized deductions before charitable contributions do not equal or exceed the standard deduction of $24,000 might benefit from bunching their charitable contributions in select tax years through use of a charitable gift fund. A planning opportunity may exist for some clients over age 70 to make Qualified Charitable Distributions from their individual retirement accounts ("IRAs") in conjunction with the new standard deduction.

OTHER PROVISIONS

- Section 529 education account balances, previously allowed to be used only for post-secondary school expenses, may now be utilized up to $10,000 per student annually for tuition at an elementary or secondary school. Many States allow an income tax deduction for contributions to 529 accounts, thus providing a tax benefit even if contributions are immediately used to pay tuition. Note, however, that contributions to 529 accounts are treated as gifts for Federal gift tax purposes so clients must weigh the benefits of the state income tax deduction against the estate tax benefits of directly paying for education and also funding annual exclusion gifts.
- The individual mandate of the Affordable Care Act requiring individuals to purchase health insurance is repealed.
- Conversions of Individual Retirement Accounts to Roth IRAs are still allowed under the Act and may still be appropriate based on a client's particular circumstances. However, the ability to undo the conversion has been eliminated. Undoing the conversion previously was beneficial if the account had fallen in value prior to the due date of the tax return.

ESTATE AND GIFT TAXES

- The estate and gift tax exemption has been doubled from $5 million to $10 million and is indexed for inflation post-2011. Due to this indexing, effective January 1, 2018 the exemption is $11.2 million per individual. The generation skipping transfer tax will apply the same exemption limits as the estate and gift tax.
- The top Federal estate and gift tax rate remains 40%.
- Portability continues to apply only to the Federal estate and gift tax, not the Federal generation skipping transfer tax or state estate taxes.
- The step-up in tax basis of inherited assets to date of death value continues to be available for assets includable in the decedent's estate.
- The annual exclusion gift amount in 2018 is increased to $15,000 per donee.

As a result of the dramatic increase in the Federal estate and gift tax exemption, many clients who previously would have had taxable estates may no longer be in this position. Complicating matters, the higher exemption sunsets on December 31, 2025 and, thereafter, the exemption will return to $5 million indexed for post-2011 inflation. We will review with clients individually whether creating trusts, adding to existing trusts, or making annual exclusion gifts continues to be good estate planning under their particular circumstances. Planning is still important in the many States which continue to impose a state-level estate tax. Many States have current laws which allow their exemption amounts to match the Federal exemption amount, and how these States react to the doubling of the Federal exemption remains to be seen. Importantly, clients should review their estate planning documents and the titling of their assets to confirm dispositive intent. Many older documents contain formulaic clauses which fund family trusts up to the limit of the Federal estate tax exemption. While that may have been appropriate when the exemption level was much lower, these clauses now would have the effect of transferring much more wealth to the family trust and much less to a surviving spouse, either outright or via a marital trust.

The applicability of the Act is client-specific. Please speak with your KLS advisor regarding your personal circumstances to determine whether any planning opportunities arise under the new law.

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