CREATIVE PLANNING

Tax Reform Update

December 18, 2017

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The House and Senate Republicans released their joint version of the Tax Cuts and Jobs Act on Friday. Both chambers will vote on the legislation this week and are expected to pass the bill, which will then be sent to the White House for the President's signature. Below is information on many of the changes included in the bill. Most changes are effective January 1, 2018 and none will affect 2017 income tax returns filed during 2018.

Individual Income Tax Rates:

Married, Filing Joint		
Income Between		Tax Rate
$ -	$ 19,050	10%
$ 19,051	$ 77,400	12%
$ 77,401	$ 165,000	22%
$ 165,001	$ 315,000	24%
$ 315,001	$ 400,000	32%
$ 400,001	$ 600,000	35%
$ 600,001	and above	37%

Single		
Income Between		Tax Rate
$ -	$ 9,525	10%
$ 9,526	$ 38,700	12%
$ 38,701	$ 82,500	22%
$ 82,501	$ 157,500	24%
$ 157,501	$ 200,000	32%
$ 200,001	$ 500,000	35%
$ 500,001	and above	37%

The number of income tax brackets remains the same, but the rates and applicable income thresholds are adjusted and the top rate is lowered from 39.6% to 37%. The individual income tax rates are effective beginning January 1, 2018 and are set to expire after 2025.

The Alternative Minimum Tax is still in place for individuals, but with an increased exemption for tax years 2018-2025. The exemption is increased to $109,400 for married taxpayers filing jointly and $70,300 for all other taxpayers. The exemption phases out beginning at $1,000,000 and $500,000, respectively. The exemption and phase out amounts are indexed for inflation.

Capital gain tax rates are unchanged at 0%, 15% and 20%. The brackets for capital gain income are unchanged as well, which means they will not follow the cut offs of brackets listed above. Instead, the rates apply to where previous brackets would have fallen. For 2018 the 0% rate will apply up to $77,200 for joint returns, $38,600 for single filers, 15% will apply up to $479,000 for joint returns, $425,800 for single filers, and 20% on income in excess of those amounts. These amounts are indexed for inflation.

The net investment income tax remains unchanged at 3.8% for modified adjusted gross income over $250,000 for taxpayers filing jointly, $200,000 for taxpayers filing as single, and $12,500 for trusts & estates.

Individual Taxpayer Deductions:

- The standard deduction is increased to $24,000 for taxpayers filing jointly and $12,000 for taxpayers filing single. The deductions were $12,700 and $6,350, respectively. The increased deduction is effective for 2018 through 2025.

- Personal exemptions are eliminated, effective 2018 through 2025.

- State and local income taxes, sales tax, real estate and personal property taxes are grouped together and deductible up to $10,000 per year in total. Previously there was no limit to the deductions. The limitation expires after 2025.

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- For mortgage debt on personal residences originating after December 15, 2017, interest is deductible on principal up to $750,000 for tax years 2018-2025. Mortgages in place prior to that date retain deductions for interest on up to $1,000,000 of principal. Mortgages on up to two personal residences can still be deducted, under the total principal limits. Beginning in 2026 the law reverts to a limitation on interest for principal up to $1,000,000 for mortgages originated at any time. Additionally, deduction for any home equity debt interest is suspended for tax years 2018-2025.

- Medical expenses are deductible as an itemized deduction for any portion that exceed 7.5% of adjusted gross income, regardless of the taxpayer's age. The reduction of this limitation is in place for 2017 and 2018 only.

- Charitable Donations:
  - Cash charitable donations are limited to 60% of adjusted gross income, increased from 50%.
  - No deduction is allowed for donations to higher education institutions when, in exchange, the payor receives the right to purchase tickets or seating at an athletic event.
  - Qualified Charitable Distributions, which are distributions from a qualified retirement accounts directly to a charity by taxpayers over 70.5, remains unchanged and available up to $100,000. This method of charitable donations will be increasingly valuable as fewer taxpayer itemize their deductions and are therefore unable to benefit from cash or property donations.

- Miscellaneous itemized deductions are suspended for tax years 2018-2025. These include tax preparation fees, unreimbursed employee business expenses, investment expenses, professional and union dues.

- Deductions for casualty losses are limited to those attributable to federally declared disaster areas for tax years 2018 -2025.

- Expenses for a work related move are not deductible for tax years 2018-2025. During that same period qualified moving expenses paid by an employer are not excluded from the employee's gross income.

- Overall limitations to itemized deductions are repealed for tax years 2018-2025.

- Payment of alimony pursuant to a divorce decree are not deductible by the payor for divorce or separation agreements executed after December 31, 2018. Income and deductions related to agreements exiting prior to that date will not be affected.

Business Taxes:

The top corporate tax rate is lowered from 35% to 21% beginning January 1, 2018. This applies to companies taxed as C-Corporations. The Alternative Minimum Tax is repealed for corporations and no change is made to the 35% rate applicable to personal service corporations.

Qualified business income that is taxable on individual income tax returns, including partnerships, LLC's, sole-proprietors and S-Corporation income, will receive a deduction of 20% of business income, subject to limitations. Qualified business income does not include wages or guaranteed payments paid from the business to the owners.

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The 20% deduction is phased out beginning when taxpayer's total income is $315,000 for couples, $157,500 for taxpayer's filing single, completely phasing out when income is $415,000 and $207,500, respectively.

Once you are past the phase out amounts your total deduction begins to be limited to the lessor of qualified business income or, the greater of 50% of W-2 wages paid by the business, or the sum of 25% of the W-2 wages paid plus 2.5% of the unadjusted basis of all qualified property. Qualified property is defined as depreciable tangible property placed in service before the end of the taxable year, whose depreciable life is at least ten years and the depreciable life of the property has not ended prior to the close of the taxable year.

Specified service businesses, which are any businesses which involves the performance of services, are eligible for the deduction only up to the phase out levels noted above. These include the fields of health, law, consulting, athletics, financial services, or any business where the reputation or skill of the employees and owners is a principal asset.

The deduction is made from taxable income, it does not affect adjusted gross income. Net pass-through income after the 20% deduction is subject to taxpayer's marginal income tax rates, listed above. If the taxpayer has a net qualified business loss, that loss will carry over to the next year and can be used to offset qualified business income in that year.

Business Deductions:

Business interest expense is now subject to a limitation for some taxpayers, while previously all business interest was deductible. Beginning in tax year 2018 business interest is limited to the sum of business interest income plus 30% of adjusted taxable income. Taxpayers with average annual gross receipts less than $25 million are exempt from the limitation.

Any interest expense that is not deductible will be carried forward indefinitely. For pass-through entities the limitation is applied at the entity level rather than the individual level. Business interest does not include investment interest.

Additional first year depreciation, or bonus depreciation, is expanded to be 100% of the cost of qualified assets placed in service September 27, 2017 through December 31, 2022. Beginning in 2023 the allowable bonus depreciation is reduced by 20% per year, making 80% bonus depreciation apply in 2023 and 0% bonus apply in 2027. Also, all property will now be eligible even if the original use does not commence with the taxpayer, previously only new assets qualified for bonus depreciation.

Section 179 expensing is increased to $1,000,000 and the phase out is increased to begin at $2,500,000 of total assets placed in service. Expensing of sport utility vehicles is still limited to $25,000. All numbers are now indexed for inflation beginning in 2019.

Passenger automobiles are subject to limited depreciation. The limits are increased to $10,000 the first year, up from $3,160 currently, $16,000 in the second year, $9,600 in the third year and $5,760 for fourth and later years for vehicles placed in service after 2017.

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Section 199 deduction for domestic production activities is repealed.

Deductions for activities which are considered entertainment or recreation are no longer deductible. Previously 50% of these costs were deductible.

Corporations with net operating loss deductions are now limited to 80% of taxable income for any losses arising after December 31, 2017.

Other Items:

The Child Tax Credit will increase from $1,000 to $2,000 per child under age 17, with up to $1,400 being refundable. The credit begins phasing out when income is at $400,000 for joint tax returns, $200,000 for single taxpayers, and is completely phased out when income is $440,000 and $240,000, respectively. This change expires after 2025.

Conversions of one type of IRA to another type, often traditional IRA's to Roth IRA's, can no longer be recharacterized back to their original account type beginning with conversions occurring January 1, 2018.

The penalties for not having health insurance, which were a part of the Affordable Care Act, are eliminated beginning in 2019.

Items That Are Not Changing:

No changes are made to student loan interest deductions, retirement accounts, educator expenses or higher education expenses and credits. No changes are made to exclusions available on gains from the sale of personal residences. The credit available for adoption expenses remains in place.

Original drafts of the bill included a provision to require securities to be sold a first-in-first-out basis, rather than specifically identifying the shares sold. This change is not included in the final bill.

This is the largest tax law change the country has seen in decades. In addition to the items summarized here there are many additional provisions, most of which only apply to a very small group of taxpayers. Many of the changes follow what we anticipated would be included in the final bill and have discussed in previous newsletters. There is still time to plan and make any necessary changes before the end of the year.