Wealth Planning Insights
The Tax Cuts and Jobs Act: What Does It Mean for You?

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Highlights

- After passage in Congress on December 20, the tax bill is expected to be signed into law by President Trump in the coming days. Although a Senate rule required a last-minute name change, we refer to the law as the Tax Cuts and Jobs Act (TCJA).
- Significant provisions in the new tax law:
  - Top corporate tax rate reduced from 35% to 21%.
  - Top individual tax rate lowered from 39.6% to 37%; applies at higher income threshold.
  - No change to preferential rates on qualified dividends or long-term capital gains.
  - Twenty percent deduction applied to qualified flow-through business income.
  - Income-based reduction of deductions (Pease provision) suspended.
  - State and local tax deduction limited to $10,000; can be a combination of income, sales, and real estate taxes.
  - Expands deductibility of cash contributions to public charities.
  - Deductible mortgage interest limited to loans of $750,000; existing loans grandfathered.
  - Deduction for home equity loan interest suspended.
  - Deductibility for miscellaneous itemized deductions suspended.
  - Alternative minimum tax retained for individuals, but with reduced effect.
  - Estate tax retained; lifetime exemption doubled.
- Notable provisions from the House and Senate bills were excluded from the final bill:
  - FIFO rule applied to stock sales/transfers.
  - Repeal of medical expense deduction.

The New Tax Law: Noteworthy Changes

The following analysis focuses on the tax provisions that may significantly affect higher-income individual taxpayers. Please refer to our *Investment Insights*, "Unwrapping Tax Reform: Implications for Markets," which explores the economic and investment implications of the new tax law.

Temporary vs. Permanent

Except as otherwise noted, the tax law changes discussed below take effect on January 1, 2018, and are not permanent. They will apply only through 2025. Beyond this, the provisions will revert to the tax law that is currently in effect. As a result, some of the changes discussed are characterized as suspended, rather than repealed.

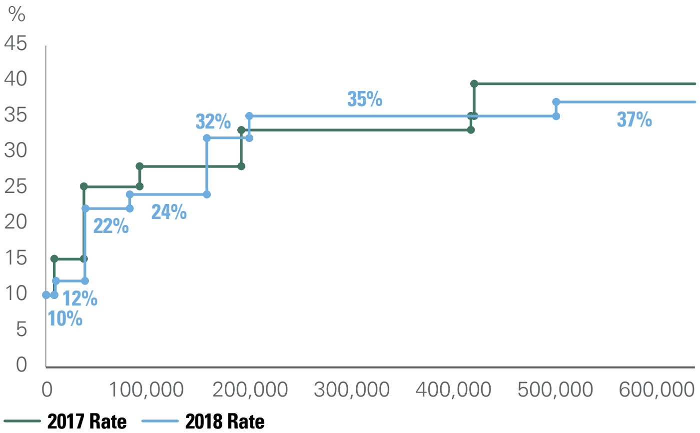
Tax Rates and Brackets

The top tax rate for individuals has been reduced from 39.6% to 37% (see Exhibit 1). Additionally, the threshold at which the top rate takes effect has been increased, so that in most cases more income will be taxed at lower rates. For individuals, the top rate threshold moves from $418,400 to $500,000. Married individuals filing jointly will see the top rate threshold increase from $470,700 to $600,000. The fact that the threshold for the top rate for married taxpayers is less than twice that for single taxpayers is an example of the "marriage penalty." Married taxpayers could see more of their combined income taxed at the highest bracket than if they were not married and filed as single.

As noted in Exhibit 2, the top preferential tax rate on qualified dividends and long-term capital gains has not changed and still includes the 3.8% net investment income tax (NIIT). However, the top rates on ordinary investment income decrease by 2.6% as a result of the reduction in the top tax rate from 39.6% to 37%.

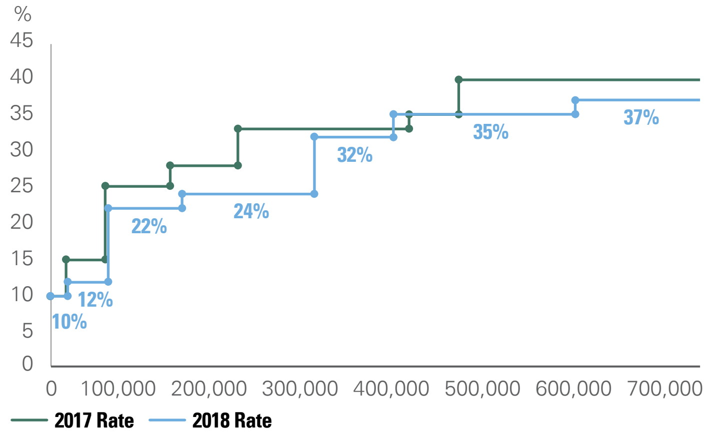
Exhibit 1: Federal Individual Income Tax Rates for 2017 and 2018

Single Individuals



Year	Tax Rate	Income
2017	10%	0–$9,325.00
	15%	$9,325.01–$37,950.00
	25%	$37,950.01–$91,900.00
	28%	$91,900.01–$191,650.00
	33%	$191,650.01–$416,700.00
	35%	$416,700.01–$418,400.00
	39.60%	$418,400.01
2018	10%	0–$9,525.00
	12%	$9,525.01–$38,700.00
	22%	$38,700.01–$82,500.00
	24%	$82,500.01–$157,500.00
	32%	$157,500.01–$200,000.00
	35%	$200,000.01–$500,000.00
	37%	$500,000.01

Married Individuals Filing Joint Returns



Year	Tax Rate	Income
2017	10%	0–$18,650
	15%	18,650.01–75,900.00
	25%	$75,900.01–$153,100.00
	28%	$153,100.01–$233,350.00
	33%	$233,350.01–$416,700.00
	35%	$416,700.01–$470,700.00
	39.60%	$470,700.01
2018	10%	0–$19,050.00
	12%	$19,050.01–$77,400.00
	22%	$77,400.01–$165,000.00
	24%	$165,000.01–$315,000.00
	32%	$315,000.01–$400,000.00
	35%	$400,000.01–$600,000.00
	37%	$600,000.01

Source: Bessemer Trust

Exhibit 2: Top Tax Rates for Investment Income

Investment Income	Current Top Tax Rate	NIIT	Current Combined Top Rate	TCJA Top Tax Rate	NIIT	TCJA Combined Top Rate	Change
Qualified Dividends	20.0	3.8	23.8	20.0	3.8	23.8	No change
Long-Term Capital Gains	20.0	3.8	23.8	20.0	3.8	23.8	No change
Nonqualified Dividends	39.6	3.8	43.4	37.0	3.8	40.8	(2.6)
Short-Term Capital Gains	39.6	3.8	43.4	37.0	3.8	40.8	(2.6)
Rents, Royalties, Other	39.6	3.8	43.4	37.0	3.8	40.8	(2.6)

Deduction for Qualified Business Income

The TCJA provides a deduction for up to 20% of the qualified business income from flow-through entities, such as partnerships, S Corporations, LLCs, and sole proprietorships. It will also apply to qualified REIT dividends, cooperative dividends, and publicly traded partnerships. The deduction would not be allowed in computing adjusted gross income, so it will not affect limitations based on adjusted gross income, such as deductible charitable giving limits. Instead, it is allowed as a deduction, reducing taxable income. Trusts and estates will be eligible for the deduction. It is set to expire at the end of 2025.

The deduction begins to phase out for business income from specified service businesses for taxpayers with taxable income beyond a threshold of $157,500 for single taxpayers and $315,000 for married taxpayers filing jointly. Specified services income is defined to include income from any trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of the business is the reputation or skill of one or more of its employees or owners. It also includes businesses involving the performance of services in investing and investment management, trading or dealing in securities, and partnership interests or commodities. Engineering and architecture services, however, will qualify for the deduction.

A limitation on the deduction will apply based on wages paid and a capital allowance, but this will only apply to taxpayers with taxable income beyond the thresholds noted above.

So who exactly will benefit from the 20% deduction on flow-through business income?

- Owners of any partnerships, S Corporations, LLCs, or sole proprietorships to the extent their taxable income does not exceed $207,500 for a single taxpayer and $415,000 for married taxpayers filing jointly. (Phaseout ranges begin at taxable income levels of $157,500 and $315,000, respectively, for single taxpayers and married taxpayers filing jointly.)
- Owners of partnerships, S Corporations, LLCs, or sole proprietorships that generate qualified business income, regardless of their level of taxable income. Note that qualified business income excludes income from the service businesses specified above. Further, a wage and capital allowance based limitation may apply for taxpayers with taxable income above the $157,500/$315,000 thresholds.

Itemized Deductions

Pease provision: An income-based reduction in allowable itemized deductions known as the Pease provision has been suspended by TCJA. This provision operated to reduce itemized deductions for higher-income taxpayers by 3% of adjusted gross income (AGI) above a certain threshold.

State and local taxes: The TCJA retains the deduction for state and local taxes, but the deductible amount is capped at a total of $10,000. This applies to income, real estate, and sales taxes. The provision will likely have a significant effect on residents of high-tax states such as California, New Jersey, and New York.

The TCJA also contains a provision that will prevent taxpayers from claiming a current-year deduction for prepayment of 2018 state estimated taxes. Taxpayers who are not subject to alternative minimum tax in 2017 should still consider payment of any remaining 2017 state tax liability prior to December 31, 2017.

Charitable contributions: In a positive development, the TCJA increases the percentage limitation for cash contributions to public charities from 50% of adjusted gross income (AGI) to 60% of AGI. This is welcome news for taxpayers who are philanthropically inclined and who often run up against the limits for deductibility. It may also help those with charitable contribution carryforwards that might otherwise expire.

Mortgage interest: The TCJA restricts the amount of deductible mortgage interest on future loans to $750,000, a decrease from the current level of $1 million. This will apply to new mortgages taken out after December 15, 2017, and importantly, will not affect the deductibility of interest on existing loans. The TCJA also suspends the deductibility of home equity loan interest; this restriction will apply to existing loans.

Miscellaneous itemized deductions: The TCJA suspends the deduction for all miscellaneous itemized deductions, including tax preparation fees, investment management fees, and employee business expenses.

Alternative Minimum Tax (AMT)

The TCJA retains the individual AMT and includes a modest increase in the exemption amount. This additional tax has historically applied to taxpayers who claim high state and local tax deductions and miscellaneous itemized deductions. Since both of these deductions have been greatly scaled back or fully suspended in the new law, we believe AMT will affect far fewer taxpayers in the future. However, with the loss of these deductions, many former AMT taxpayers may still face an increased tax liability.

Effect on State Tax Liability

Many states base their tax calculation on federal taxable income. Since this may increase for higher-income taxpayers with the loss of itemized deductions, state taxes may increase as well.

Estate, Gift, and Generation-Skipping Transfer Taxes

The TCJA retains the estate tax (the House bill sought to repeal it) but doubles the exemption amount. The exemptions from the gift tax and generation-skipping transfer (GST) tax will also be doubled. Beginning in 2018, these exemptions will be $11.2 million per individual, with inflation adjustments going forward. Thus, married couples will be able to shield $22.4 million from the federal estate tax.

Year-End Tax Planning

Now that the TCJA details are known, several year-end planning strategies should be considered:

Prepay State and Local Taxes

Note: The strategies noted below will only produce a tax benefit to the extent taxpayers are not subject to AMT in 2017.

- Since the deduction for state and local taxes will be significantly scaled back, individual taxpayers should consider prepaying 2017 state estimated taxes prior to December 31, 2017. This would apply to:
  - Fourth-quarter estimated tax payments, usually due January 15.
  - Any expected 2017 state tax balances due on April 15, 2018, normally paid with an extension request.
- Markets have been strong in 2017. Year-end tax projections should be prepared with the most recent taxable income and gain estimates.
- The reduction in allowable state and local taxes will also apply to real estate taxes. To the extent possible, prepayment of 2018 assessments prior to December 31, 2017, should also be considered. Rules for prepayment will vary by taxing jurisdiction, so this may not be an option in every case.

Alternative Minimum Tax

Note: Unlike the prepayment strategies discussed above, the following strategies would only apply to taxpayers who are subject to AMT in 2017.

Although by definition it is never good to be subject to AMT (you are paying more tax than you would otherwise owe under a regular tax calculation), it can present some planning opportunities. Taxpayers can take advantage of the lower AMT rate of 28%.

- High-income taxpayers should consider accelerating ordinary taxable income into 2017 to take advantage of the lower AMT rate. One way to do this is through a Roth IRA conversion. The amount converted must be included in taxable income in the year of conversion.
- Conversely, high-income taxpayers subject to AMT in 2017 should consider deferring additional charitable giving into 2018. The tax benefit achieved for incremental giving in 2017 would likely be 28%, as compared to a potential tax benefit of 37% or higher in 2018.

Alternative minimum tax is notoriously complex. Preparation of accurate tax projections is strongly recommended prior to implementing these strategies.

Tax Planning for 2018 and Beyond

With change, there often comes opportunity. The TCJA presents some very significant tax changes for high-income taxpayers. Numerous tax planning opportunities may also manifest:

- To the extent that business income from flow-through entities does not qualify for the 20% deduction, consider restructuring for a more favorable result.
- The loss of deductions for state and local taxes is a significant downside to TCJA for many taxpayers. Changing tax residence to a low- or no-tax environment may become a more attractive option.
- The after-tax interest cost of a home equity loan will increase with the corresponding loss of deduction. Consider paying off any outstanding home equity loans.
- The increased lifetime estate tax exemption presents additional planning opportunities. A fresh look at your estate plan in 2018 may be fruitful.

We hope you find this information helpful. We will continue to analyze the new legislation and share our best thinking. Please contact your client advisor or one of Bessemer's senior tax consultants if you have any questions or wish to discuss the implications of the new tax law further.

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