Breaking Down the Tax Bill

Over the last few months, Republicans in Congress have labored over a new tax bill. On December 22, President Trump signed the final bill into law.

It's the most significant overhaul of the tax code since 1986 – and it's something political, legal, and financial professionals will be analyzing for months to come. The *Tax Cuts and Jobs Act*, as it's officially known, contains many provisions affecting everyone from parents to small business owners – provisions that could have a significant impact on your overall finances.

Taxation is a politically-charged subject, of course. Everyone has an opinion, because everyone's got a stake. I have opinions of my own, of course, but I'm not a political analyst. I'm *your* financial advisor. So, I've tried to write this letter to be as neutral as possible. For that reason, you're about to see a lot of numbers.

Most of these provisions go into effect in 2018. That means we should start educating ourselves on the basics of the new tax bill now. To help, I've prepared a sort of primer that breaks down some of the main changes to the tax code. Understand, this letter is not intended to be a complete, exhaustive analysis of the entire bill. But at least this way, you'll be familiar with some of the broad strokes.

As always, if you have any questions, please don't hesitate to let me know. Additionally, if you would ever like me to confer with your personal tax advisor (or recommend a good one!), I would be happy to do so.

Sincerely,

Daniel Langworthy, COA, CIMA®, CPWA®

Basic Provisions of the *Tax Cuts and Jobs Act*

Before we dive into the new bill, it's important to understand that most of the following changes affecting individuals and couples are set to expire in 2025. Thereafter, tax rates and other provisions revert to their current form unless extended by a future Congress.

Most of the changes affecting corporations, on the other hand, are permanent.

CHANGES TO TAX RATES – INDIVIDUALS & MARRIED COUPLES

When Republicans in the House of Representatives released their initial version of the bill, the plan was to shrink the number of tax brackets from seven to four. The final bill retains all seven brackets; however, rates for most brackets have come down.[1]

Current Tax Brackets	New Tax Brackets in 2018	Income for Individuals	Income for Married Couples
10%	10%	Up to $9,525	Up to $19,050
15%	12%	$9,526 to $38,700	$19,051 to $77,400
25%	22%	$38,701 to $82,500	$77,401 to $165,000
28%	24%	$82,501 to $157,500	$165,001 to $315,000
33%	32%	$157,501 to $200,000	$315,001 to $400,000
35%	35%	$200,001 to $500,000	$400,001 to $600,000
39.6%	37%	Over $500,000	Over $600,000

Date of Effect: January 1, 2018

Expiration: December 31, 2025

CHANGES TO TAX RATES – CORPORATIONS

Fun fact: The *Tax Cuts and Jobs Act* is the largest one-time tax cut for corporations in U.S. history, which are set to see their tax rate drop from 35% to 21%.[2] This is slightly higher than the 20% tax rate Republicans were originally shooting for, and significantly higher than the 15% President Trump called for. But it's still a major boon for many businesses, especially large corporations, which Republicans hope will lead to more jobs and increased investment. (Hence the name of the bill.)

Date of Effect: January 1, 2018

Expiration: Permanent

CHANGES TO DEDUCTIONS – INDIVIDUALS & MARRIED COUPLES

To understand the changes being made to non-corporate deductions, it's helpful to first understand how the current tax code works.

There are two basic kinds of deductions, standard and itemized. As the IRS explains it, the standard deduction is a "dollar amount that reduces the amount of income on which you are taxed."[7] Currently, single individuals can take a standard deduction of $6,350. Married couples can take a $12,700 deduction. Married couples with children can take even higher deductions.

Under the new plan, the standard deduction goes up to **$12,000 for single individuals** and **$24,000 for married couples.**[3] That means many people will see a very nice tax cut for the next several years.

But when it comes to the standard deduction, there's a catch: you can't take it if you itemize deductions. So, while the bill doubles the standard deduction, that benefit could be offset for some because of changes to itemized deductions. This is especially true for those living in high-tax states.

Here are some changes to common itemized deductions[3]:

- **Mortgage interest:** Currently, people can deduct up to $1 million on mortgage interest payments for newly purchased homes. That's still the case for properties purchased *before* December 15, 2017. But for homes purchased after that date, you can only deduct up to $750,000. This includes your primary residence and one additional "qualified residence," like a cabin or mobile home.
- **State and local taxes:** A popular deduction is to write off state and local tax payments from federal tax payments. Originally, the Republican tax plan called for removing this particular tax break altogether, and you may have seen that reported in the news. This did not sit well with representatives from high-tax states, however, so a compromise was reached. Now, taxpayers can deduct **no more than $10,000** of any combination of state income taxes, local income taxes, and property taxes.
- **Medical expenses:** Originally, the House Republicans' version of the bill would have eliminated all deductions for medical expenses, but the final version is quite different. Currently, you can deduct out-of-pocket medical expenses that exceed 10% of your "adjusted gross income." (This is your total gross income minus specific deductions.) In 2018, however, you can only deduct out-of-pocket expenses that exceed *7.5%* of your adjusted gross income.[4]

  In 2019, the deduction reverts to the original level of 10%.[4]

Date of Effect: January 1, 2018

Expiration: December 31, 2025 for changes to mortgage interest and state/local income tax deductions. January 1, 2019 for changes to medical expense deductions.

CHANGES TO DEDUCTIONS – BUSINESSES

One of the most significant provisions in the new bill is how it affects small businesses – specifically "pass-through" businesses.

What is a pass-through business? Well, for many small business owners, business income is taxed the same as their *individual* tax rate. In other words, any business income *passes through* to the owner to be taxed at the owner's individual level. Essentially, this is a way to ensure a business owner doesn't have to pay income taxes twice.

The new bill allows pass-through businesses to take a 20% deduction on their business income taxes. However, owners of service-oriented businesses (like a doctor's office) cannot take the deduction *unless* their taxable income is less than $315,000 (if married) or $157,000 (if single).[5]

Date of Effect: January 1, 2018

Expiration: December 31, 2025

CHANGES TO THE ALTERNATIVE MINIMUM TAX

The Alternative Minimum Tax, or AMT, has long been one of the most complex aspects of the tax code. Enacted in 1969, the AMT was originally designed to prevent the wealthy from using a dizzying array of credits, deductions, and loopholes to avoid taxes altogether. Over the decades, however, the AMT began hitting those who were already paying a host of other taxes.

Calculating what amount people actually pay is a complex process, and the new bill doesn't change that. What *does* change, however, is the threshold at which people are exempt. For individuals, the exemption level increases from $54,300 to $70,300. For married couples who file jointly, the exemption rises from $84,500 to $109,400.[6]

For corporations, on the other hand, the AMT is eliminated altogether. Most industries claim this will help them spend more on research, expansion, and jobs, which would surely be welcome news to investors.

Date of Effect: January 1, 2018

Expiration: December 31, 2025 for individuals and married couples. For corporations, the elimination of the AMT is permanent.

CHANGES TO THE ESTATE TAX

Long derided as a "death tax" by its detractors, the estate tax is *not* being abolished, as was originally the case. The number of people required to pay it, however, will decrease. Currently, estates passed onto heirs are taxed up to 40%, with exemptions for those with estates worth up to $5.49 million ($10.98 million for married couples).

The new law doubles both levels.[4]

Date of Effect: January 1, 2018

Expiration: December 31, 2025

OTHER CHANGES

The *Tax Cuts and Jobs Act* is over five-hundred pages long. As you can imagine, it contains a *lot* of provisions – far too many to cover in a single letter. But here's a quick rundown of some other significant changes[4]:

- **End of the Individual Mandate:** After failing to repeal the Affordable Care Act, also known as Obamacare, earlier in the year, Republicans were nevertheless able to repeal one of the health care law's signature provisions. The individual mandate, which requires people above a certain income level to buy insurance or pay a penalty, will end beginning in 2019.
- **Boost to the Child Tax Credit:** Currently, parents up to a certain income level may claim a $1,000 credit for each child under age 17. Under the new law, this credit rises to $2,000 for both single individuals and married couples making up to $400,000.
- **Moving Expenses and Tax Preparation Deductions:** Two more itemized deductions are consigned to the trash bin of history. Starting next year, people can no longer deduct either moving or tax preparation expenses.

WHAT *DIDN'T* CHANGE

Congress debated many provisions that ultimately didn't make it into the final bill. These include:

- **Student Loan Deductions:** The original House bill eliminated the option of deducting student loans, but the final bill left it untouched.
- **Changes to 401(k) Accounts:** At one point, it was rumored that the bill would restrict the amount of pre-tax dollars people could contribute to their 401(k). In the end, the rules governing 401(k) accounts went unchanged.
- **Capital Gains When Selling a Home:** Married couples can deduct up to $500,000 in capital gains when selling their home, so long as they have lived it in for at least two out of the five years before the date of sale. Initial drafts of the bill would have limited this, but the provision escaped unscathed.
- **Selling Stock:** When selling shares of a stock or mutual fund, investors can choose which shares to sell. This enables them to sell only those shares that would incur the least in taxes. The Senate tried to clamp down on this, to no avail.

FINAL ANALYSIS

Still with me? Haven't fallen asleep yet? At least this letter isn't as long as the tax bill itself!

To be honest, there really can be no "final analysis" at this point. Tax experts are still wrestling with many of the bill's provisions, and it may be months before we know all the consequences, intended or otherwise.

Furthermore, despite the fact President Trump signed the bill into law, plenty of questions remain, including:

- What happens if Democrats regain control of Congress? Will parts of the law be repealed?
- What happens by 2026? Will a future Congress extend these tax cuts, or will they be allowed to expire?
- Will this bill create millions of new jobs and expand economic growth? Or will it merely add millions more to the national deficit? You can find experts on both sides of the issue. All I can say is, "Stay tuned."

Generally speaking, though, the following things are clear:

1. Most Americans will enjoy a tax cut, at least temporarily.
2. Most businesses will see a significant reduction in taxes, which could, in theory, stimulate both the markets and the overall economy.

Taxes are a loaded topic, and it's impossible to predict exactly what the future holds. That's why my team and I will continue to examine both the new tax code and the markets, so we can keep you informed about any potential issues *or* opportunities.

As always, remember that we at Fortress Financial are here to help you work toward your financial goals. Please let us know if there's ever anything we can do.

Sources

[1] Rob Berger, "The New 2018 Federal Income Tax Brackets & Rates," *Forbes,* December 17, 2017. https://www.forbes.com/sites/robertberger/2017/12/17/the-new-2018-federal-income-tax-brackets-rates/#769a8d28292a

[2] Heather Long, "The final GOP tax bill is complete. Here's what is in it." *The Washington Post,* December 15, 2017. https://www.washingtonpost.com/news/wonk/wp/2017/12/15/the-final-gop-tax-bill-is-complete-heres-what-is-in-it/?utm_term=.0c659bee9706

[3] Ron Lieber and Tara Siegel Bernard, "What's in the Tax Bill, and How It Will Affect You," *The New York Times,* December 16, 2017. https://www.nytimes.com/2017/12/16/your-money/tax-plan-changes.html?_r=0

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[5] Michael Rapoport, "What the Tax Bill Means for Pass-Through Business Owners," *The Wall Street Journal,* December 19, 2017. https://www.wsj.com/articles/what-the-tax-bill-means-for-pass-through-business-owners-1513720953

[6] Jeanne Sahadi, "What's in the GOP's final tax plan," *CNN Money,* December 22, 2017. http://money.cnn.com/2017/12/15/news/economy/gop-tax-plan-details/index.html?iid=EL

[7] "Standard Deduction at a Glance," *Internal Revenue Service,* https://www.irs.gov/credits-deductions/individuals/standard-deduction-at-a-glance