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Capitalizing on Tax Reform: 2018 Strategies and Long-Term Opportunities

The recently passed tax law creates several planning opportunities for high-net-worth individuals to consider.

On December 22, 2017, Congress passed the Tax Cuts and Jobs Act. President Trump signed into law the most sweeping U.S. tax legislation in more than 30 years. The law, which takes effect in 2018, creates wide-ranging changes for individuals at all income levels, as well as for corporations.

Most notably, individuals will see:

- Changes to marginal tax rates and brackets
- More limits on itemized deductions but a significantly higher standard deduction
- Deductions for income from LLCs, S Corporations, and other pass-through entities
- A doubling of the amount of wealth that can be passed to younger generations without incurring estate or gift tax

Corporations will see:

- Tax rate decrease from 35% to 21%
- Limits on interest deductions
- Changes in how foreign profits are taxed

Many of the changes for individuals, however, are scheduled to sunset after 2025, a concession that Republicans made to allow the bill to avoid being filibustered in the Senate.

The new legislation creates several planning opportunities for high-net-worth individuals to consider. We provide an overview of the changes for individuals and businesses, and look at how the reforms could affect tax strategies in 2018 and beyond.

Individual taxpayers will see changes related to many aspects of their income taxes starting in 2018. Here is an overview of the most significant changes for high-net-worth individuals and families.

Will Tax Reform Raise or Lower My Tax Bill?
Understandably, that is the first question people ask about the new tax legislation. The answer is: "it depends." Some of the biggest factors that the answer depends on include whether you live in a state with high income and property taxes, how much income you earn, how much you contribute to charity, and whether you own a business. For many taxpayers, the changes will be pulling on opposite ends of the rope, and it won't be possible to determine the net effect until your tax advisor runs the numbers for your situation.

For high-net-worth individuals, here is a rundown of some of the most important changes based on whether they are expected to raise or lower tax liability.

Lower Tax Liability

- Top marginal tax rate decreases to 37%; tax rates at other income levels decrease, as well
- Standard deduction nearly doubles
- Pease limitations on deductions are eliminated
- Estate tax exemption doubles
- AMT exclusion amount increases
- Income from pass-through entities qualifies for a 20% deduction; but this is subject to income phase-outs
- Child tax credit doubles

Raise Tax Liability

- Deductions for state and local taxes are limited to $10,000
- Amount of mortgage debt for which interest can be deducted decreases from $1 million to $750,000; this lower limit only applies to new mortgages
- Personal exemption is eliminated
- Holding period requirement for long-term capital gains treatment of carried interest increases from one year to three years

Marginal Income Tax Rates and Brackets
The highest marginal income tax rate decreases from 39.6% to 37%, applying to taxable income above $500,000 for single filers and $600,000 for married filers. The tax rates and brackets at lower income levels also change, with many taxpayers seeing a reduction in their marginal rates.

Marginal Tax Rates and Brackets
The Tax Cuts and Jobs Act lowers the top marginal income rate from 39.6% to 37%, and changes the tax rates and brackets at other income levels, as well.

Unmarried Individuals

Previous 2018		*New 2018*	
Income	**Rate**	**Income**	**Rate**
Over $426,700	39.6%	Over $500,000	37%
$424,951- $426,700	35%	$200,001 - $500,000	35%
$195,450 - $424,950	33%	$157,501 - $200,000	32%
$93,701 - $195,450	28%	$82,501 - $157,500	24%
$38,701 - $93,700	25%	$38,701 - $82,500	22%
$9,526 - $38,700	15%	$9,526 - $38,700	12%
Up to $9,525	10%	Up to $9,525	10%

Married, filing jointly

Previous 2018		*New 2018*	
Income	**Rate**	**Income**	**Rate**
Over $480,050	39.6%	Over $600,000	37%
$424,951- $480,050	35%	$400,001- $600,000	35%
$237,951 - $424,950	33%	$315,001- $400,000	32%
$156,151 - $237,950	28%	$165,001- $315,000	24%
$77,401 - $156,150	25%	$77,401- $165,000	22%
$19,051 - $77,400	15%	$19,051- $77,400	12%
Up to $19,050	10%	Up to $19,050	10%

Sources: Internal Revenue Service (Previous 2018); U.S. Congress, Joint Explanatory Statement of the Committee of Conference (New 2018)

The law generally "broadens the tax base" by limiting itemized deductions.

Deductions and Exemptions

The law nearly doubles the standard deduction and elminates personal exemptions. The net effect is that many taxpayers will have a lower tax liability by claiming the higher standard deduction, rather than by itemizing their deductions.

Standard Deduction: The standard deduction, which is the amount that taxpayers who don't itemize their deductions get to automatically deduct from their income, increases from $6,350 for single filers and $12,700 for married filers to $12,000 and $24,000, respectively. An estimated 30% of all filers, or 45 million Americans, currently itemize their deductions, and the new, higher standard deduction could prompt about 20 million of them to choose the standard deduction, according to *The Wall Street Journal*[1].

Personal Exemption: The personal exemption, which taxpayers get to deduct from their income regardless of whether or not they itemize, was $4,150 in 2017. This exemption is eliminated for 2018 and beyond. Many higher-income taxpayers will not be affected by this change because the exemption phases out at relatively low income levels.

Pease Limitations: Currently, high-income taxpayers have the value of their itemized deductions reduced by up to 80% starting at taxable income of $261,500 for single filers and $313,800 for married filers. Starting in 2018, the Pease limitations are eliminated.

State and Local Taxes: Currently, taxpayers who itemize can deduct their state and local taxes, including income tax, sales tax, and property tax, from their income that is subject to federal income tax. Starting in 2018, those deductions are limited to $10,000, combined for all of the state and local taxes. It is important to note that the $10,000 limit is per tax return, so it doesn't double for married filers.

Mortgage Interest: Currently, taxpayers who itemize can deduct interest on mortgages, for first and second homes, of up to a combined $1 million. Starting in 2018, that amount drops to $750,000. The new limit only applies to mortgage debt incurred after December 15, 2017, so existing mortgages above those amounts are grandfathered in. Also starting in 2018, interest on home-equity lines of credit (HELOCs) will no longer be deductible. Previously, interest on up to $100,000 of HELOC debt was deductible.

Charitable Contributions: Currently, deductions for cash contributions to public charities are limited to 50% of the donor's adjusted gross income (AGI). Starting in 2018, that limit increases to 60% of AGI.

Investment Fees: Currently, investment fees in excess of 2% of the taxpayer's AGI are deductible. Starting in 2018, these fees are no longer deductible.

Medical Expenses: Currently, taxpayers who itemize can claim a deduction for medical expenses in excess of 10% of the taxpayer's income. Starting in 2018, that threshold lowers to 7.5%.

Child Tax Credit: Currently, taxpayers can claim a $1,000 credit for each dependent child, and this credit starts phasing out for non-married filers at $75,000 of income and married filers at $110,000 of income. Starting in 2018, the child tax credit increases to $2,000, and $1,400 of this is refundable. Refundable means that the taxpayer receives a check for amounts of the credit in excess of the total taxes owed. The credit starts phasing out for non-married filers at $200,000 of income and married filers at $400,000 of income.

Alimony Payments: Currently, taxpayers can deduct any alimony payments they make to an ex-spouse. But payments made through any alimony agreement signed after December 31, 2018 will not be deductible.

The increase in the standard deduction and limits on deductions for state and local taxes have created new tax-planning opportunities and challenges for high-net-worth individuals.

Estate and Gift Tax

Estate and gift taxes, along with the generation-skipping transfer tax, all continue to exist under the tax reform, but the amount that can be transferred before being subject to the 40% tax doubles. In 2017, the inflation-adjusted exemption amount was $5.49 million per individual. For 2018, that amount doubles (to approximately $11.2 million per individual) and continues to be adjusted for inflation. This means that married couples can give approximately $22.4 million to heirs without being subject to transfer taxes.

Like many of the tax changes, the higher exemption amount for wealth-transfer taxes is scheduled to sunset after 2025. The exemption amount and tax rate have changed frequently and significantly over the past century, so high-net-worth individuals should take this unpredictability into account when developing their wealth-transfer strategies, building flexibility into their trusts and other estate-planning vehicles when possible.

Alternative Minimum Tax

The Alternative Minimum Tax (AMT) is a second tax system that operates parallel to the regular income tax system. Taxpayers are required to calculate their tax liability under both systems and then pay the higher amount. Calculating the AMT requires adding back “preference items,” such as deductions for dependents and for state and local taxes, subtracting the AMT exemption amount, and then recalculating the tax liability under the AMT system. According to the Tax Policy Center, about 5.2 million people were subject to the AMT in 2017, and families who live in high-tax states are among those who are most likely to be subject to the AMT[2].

In 2017, the AMT exemption amount was $54,300 for single filers and $84,500 for married filers. In 2018, those amounts increase to $70,300 and $109,400, respectively.

Business Income from Pass-Through Entities

When a business is structured as a pass-through entity, such as an LLC, an S Corporation, a partnership, or a sole proprietorship, the profits from the business are included on the owner’s (or owners’) personal tax return and taxed under the individual income tax system. In 2018, owners of pass-through entities can deduct 20% of the business profits on their personal income tax returns. This deduction results in a top effective tax rate of 29.6% on pass-through income.

There are phase outs (starting at $157,500 for single filers and $350,000 for married filers) that limit some high-income business owners’ ability to benefit from these deductions. The amount of the deduction that a business owner can claim further depends on what industry the business is in, how much in wages the company pays, and how much tangible depreciable property the company has. For example, owners of professional services firms, such as attorneys and accountants, are the most restricted in their ability to claim the deduction.

529 Plans

Previously, contributions to 529 plans grew tax-free if the funds were used for qualified expenses related to college and other higher-educational institutions. For 2018, funds in 529 plans can also be used to pay for K-12 educational expenses, with an annual limit of $10,000 per beneficiary. The funds cannot be used for homeschooling.

Health Insurance

The penalty for individuals who don’t have health insurance, which was created as part of the Affordable Care Act, has been eliminated starting in 2018.

The changes affecting businesses aren't nearly as numerous as the changes for individual taxpayers, but the potential impact of the business tax changes is significant. Unlike the changes for individuals, many of the business changes are permanent (for now) and not scheduled to sunset in 2025.

Corporate Tax Rate
Previously, businesses that are classified as C Corporations (as opposed to being pass-through entities) faced a tax rate of 35% on profits. In 2018, the corporate tax rate decreases to 21%.

Deductibility of Interest
Previously, businesses could treat 100% of their interest on debt as an expense. From 2018 through 2021, businesses will be able to deduct interest of only up to 30% of the company's earnings before interest, taxes, depreciation, and amortization (EBITDA). In 2022, the limit switches to 30% of earnings before interest and taxes (EBIT), rather than 30% of EBITDA.

Taxation of Foreign Profits
Previously, the United States taxed profits earned by companies overseas; companies received credits for taxes paid on that income to foreign governments, and the United States did not tax foreign profits until the money was repatriated, or brought back, to the country. In 2018, the United States moves to a "territorial" tax system, in which foreign profits aren't subject to U.S. tax.

Repatriation of Foreign Profits
In 2018, the United States will charge a one-time tax on foreign profits that are repatriated. The tax will be 15.5% on cash and other liquid assets and 8% on illiquid assets.

Carried Interest
For managers of private equity funds, hedge funds, real estate funds, and other investment funds, a large percentage of their income comes in the form of "carried interest," which is the capital gains generated by the fund's investments. Currently, funds must hold an asset for at least one year for the investment to qualify for the long-term capital gains rate of 20% (plus an additional 3.8% for high-income investors); gains on assets held for less than one year are taxed at the manager's personal marginal tax rate. Starting in 2018, the holding period requirement increases to three years.

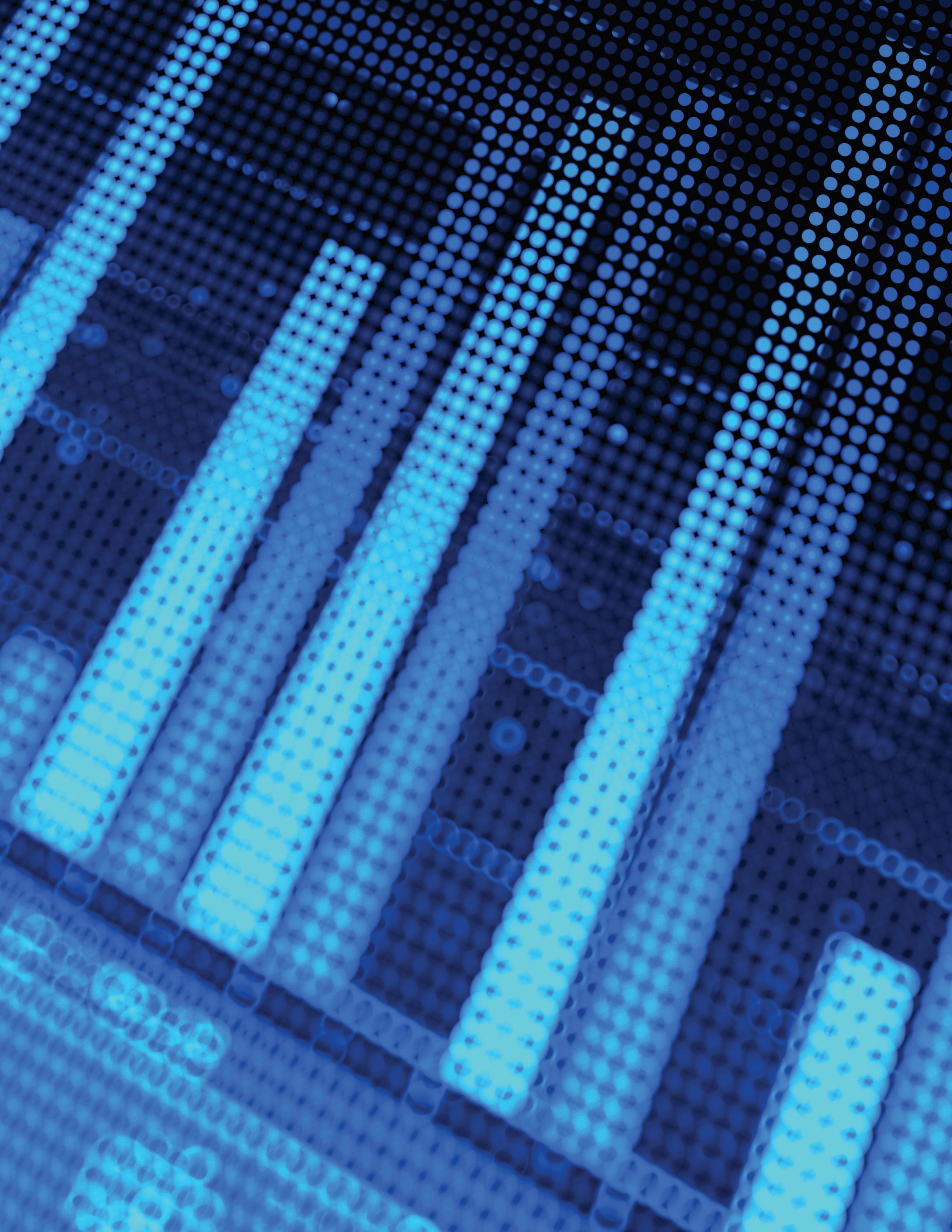
Corporate AMT
While there had been an alternative minimum tax (AMT) for corporations, in 2018, the corporate AMT is eliminated.

Tax reform brings wide-ranging and fundamental changes to how individuals and businesses are taxed.

As a result, some of the tax-planning strategies that have been implemented in years past need to be reevaluated in light of the reforms. This is especially true for wealth-transfer strategies and charitable giving strategies, as well as for business owner's choice of the proper entity for their companies.

It's also important for investors to consider the impact that tax reform will have on their equity portfolios. Although much of the broader effect of lower taxes has already been priced into the market, the actual impact on specific sectors and on U.S. economic growth will continue to come into focus over the next several quarters. William Blair's global strategist, Olga Bitel, shared her thoughts on these dynamics in a recent blog post, U.S. Tax Cuts: Pros and Cons.

To learn what the new legislation means for you and your family's tax and wealth management strategies, please don't hesitate to contact William Blair. We will continue to monitor the implementation of tax reform and other developments in Washington and keep you updated on how they might affect your plans for 2018 and beyond.



[1] Laura Saunders. *The Wall Street Journal*. "Cut Your Tax Bill: What To Do Before Jan. 1." December 19, 2017.

[2] Tax Policy Center. "What Is the AMT?"

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