Final Tax Bill eNotice

eNotice, December 2017

In just three months, from the formal introduction of the Republican Tax Framework at the end of September to the final vote in Congress on December 20, 2017, the Tax Cut and Jobs Act (H.R.1) moved with remarkable speed. It will affect individuals and businesses for years to come.

Over the next few weeks and months we will offer podcasts, webinars and sales ideas on planning for the new law. However, our immediate focus is summarizing the changes.

The Tax Cut and Jobs Act is the first major piece of tax legislation since 2012. While it may not be as sweeping as the 1986 Tax Act, nor offer the promised simplification to allow a post card sized return, the effect is one that requires Financial Professionals to revisit their client's planning and determine how to respond. **And, they must do so knowing that most provisions for individual taxpayers will sunset after December 31, 2025.** At that time tax law (for individuals, estates and gift taxes) reverts to the law as it existed in 2017 with some indexing. As a result, Financial Professionals must be careful to plan for the present but not undo any valid, current, planning.

Finally, the path the Tax Bill took shows the highly polarized atmosphere in Washington and exposes two critical areas that must be considered in any planning. Should there be a change in control in Congress or at the White House, it is reasonable to expect that much of the legislation may be subject to change, particularly if the promised boost to the economy doesn't occur. Additionally, the path exposed the ongoing need for client self-sufficiency. Given the discussions of future budget cuts and the short, but volatile, discussion of reducing deductible 401(k) contributions, clients need to become ever more self-sufficient in providing for their financial security. They may want to consider including permanent cash value life insurance, with a long-term care rider for either supplementing retirement income or offering care protection in later years.

On the pages that follow, we take a brief look at the changes and the planning opportunities they offer. Page 2 offers a summary chart comparing prior and current law, with brief comments related to each key topic. Additionally, we offer brief discussions on key client planning opportunities offered by the new Tax Bill, broken out into the areas of:

- Individual Planning
- Corporate Planning
- Pass Through Entity Planning
- Estate and Gift Planning
- Insurance Carrier Provisions

Some additional links to supporting documents are linked, below.

AXA's eNotice on the Republican Tax Framework

The Estate Tax Turns 100

Text of the Tax Cut and Jobs Act (H.R. 1)

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Summary Chart of Key Provisions and Comparisons

	Prior Tax Code	Current Tax Code	Comments
Individual Tax Rates	Seven tax brackets with the top rate of 39.6%.	Maintains seven tax brackets but with a top rate of 37%.	The Tax Bill maintains the Senate focus of seven tax brackets but with lower rates. The Affordable Care Act surcharge remains on unearned income.
Itemized and Standard Deductions	Single taxpayers had a standard deduction of $6,350 and married couples had a standard deduction of $13,000. State and local taxes, real estate taxes and mortgage interest were deductible with few limits.	Single taxpayers are now allowed a standard deduction of $12,000 and married couples had a standard deduction of $24,000.	With the reductions in some itemized deductions, and increased standard deductions, the new standard deduction will be used more widely. This will result in some tax savings for some individuals.
Exemptions for Dependents	Taxpayers were allowed $4,050 per dependent. This was subject to some increases and/or phaseouts for older or higher income taxpayers	Exemptions for dependents are eliminated.	Exemptions are folded into the newly expanded Standard Deductions. Changes are scheduled to expire after 2025.
Individual Alternative Minimum Tax (AMT)	The AMT begins to apply for taxpayers at $120,700 (single) and $160,900 (joint).	The AMT exemption rises in 2018 to eliminate the AMT for single taxpayers with incomes up to $500,000 and joint taxpayers with incomes up to $1,000,000.	Changes are scheduled to expire after 2025.
Individual Health Care Mandate	Health coverage was required or taxpayers were subject to a fine.	The individual mandate is repealed.	This was added in the Senate version for budget savings related to subsidies. This provision is not scheduled to expire.
Corporate Tax Rate	Top corporate tax rate was 35%, but with a 3% surcharge at certain income levels.	Top corporate tax rate drops to 21% in 2018. Expansion in ability to deduct depreciable assets.	Assets eligible for deductions as opposed to amortization must be purchased between September 27, 2017 and January 1, 2023.
Corporate AMT	Corporations are subject to an AMT on the differences between book and tax income.	The Corporate AMT is removed.	This provision will eliminate the taxation of life insurance death benefits in C Corporations.
Pass Through Entity (LLC, Sub S, Partnership) Taxation	100% of income passing through a K-1 form is taxed at individual rates.	For pass through business owners 20% of their K-1 is deductible There are limits on the 20% deduction for personal service corporations (CPAs, attorneys, possible some producers, etc.).	Changes are scheduled to expire after 2025.
Estate Tax Rate & Exemption	Top rate of 40% on estates over $5.6M per individual.	Top rate of 40% on estates over $11.2 per individual. Step up in basis is retained.	Changes are scheduled to expire after 2025.
Gift Tax Rates	Same as Estate Tax	Same as Estate Tax. Annual exclusion remains, as indexed.	Changes are scheduled to expire after 2025.
Insurance Carrier Taxation	The amortization and Deferred Acquisition Cost (DAC) tax has been in place for decades.	Under the final bill, a higher portion of income must be amortized over a longer period of time.	

Individual Tax Changes

The Tax Bill maintains the current 7 tax brackets although, for the most part, it drops the top tax rates. The chart (below) describes the new tax bands. The earlier House version, would have compressed the tax bands to four but in adjusting income across those bands, some taxpayers could have seen increases in their tax brackets. However, as discussed below, the rate reductions may be offset by changes in deductions and will vary widely among taxpayers and regions of the country.

Income Tax Rate		Income Levels for Those Filing As:	
2017	**2018-2025**	**Single**	**Married-Joint**
10%	10%	$0 - $9,525	$0 - $19,050
15%	12%	$9,525 - $38,700	$19,050 - $77,400
25%	22%	$38,700 - $82,500	$77,400 - $165,000
28%	24%	$82,500 - $157,500	$165,000 - $315,000
33%	32%	$157,500 - $200,000	$315,000 - $400,000
33%-35%	35%	$200,000 - $500,000	$400,000 - $600,000
39.6%	37%	$500,000+	$600,000+

There are a number of items that will affect taxes for individuals clients. However, the key ones are bulleted, below:

- The standard deduction for 2018 prior to the tax reform bill was $6,500 for individuals, $9,550 for heads of household filers, and $13,000 for married couples filing jointly. Under the new tax reform bill, those amounts will almost double to $12,000, $18,000 and $24,000 respectively. Tax filers who previously itemized deductions may now be swayed toward standard deductions with the higher threshold.
- Personal exemptions of $4,050, available in 2017 for each dependent, will be suspended with the new Tax Bill.
- Itemized deductions for state and local income, sales and property taxes (SALT) will now be curtailed. The deductions are now capped at $10,000 for SALT.
- Mortgage interest deductions were also reduced, now capped at $750,000 for new mortgages. Mortgages up to $1 million taken before December 15, 2017 will be grandfathered. Note, that the home equity interest deduction is now repealed.
- Charitable contribution limit increased to 60% of adjusted gross income for cash contributions. The five- year carry-over of unused deductions, as well as the 30% of AGI limitation for appreciated property contributions remains unchanged.
- Deductions for alimony payments, and the inclusion of alimony into income are both repealed.
- The individual Alternative Minimum Tax (AMT) remains, but with higher exemptions - $70,300 for individual filers ($109,400 for married joint filers). The parameters for the phase-out of the AMT exemption were also increased to $500,000 for single filers and $1 million for married taxpayers filing jointly. This effectively removes a wide number of individuals from the reach of the AMT.
- The repeal of Medical deductions is delayed two years.
- The new Tax Bill increases cost of living adjustments under what is known as “Chained CPI (Consumer Price Index).” The effect of Chained CPI is to slow the rate of indexing with the effect of increasing revenue.

Planning Tips: Most of the changes reflected above are scheduled to sunset after 2025. As a result, it may be difficult for individuals to weigh permanent planning changes. Financial Professionals should work with their clients on short and long-term planning based on after-tax income flows over the next several years. There had been some speculation that these changes could cause an exodus from high tax states and possibly depress home prices. That remains to be seen as few people may change their address for a possible short-term tax change.

Given that these tax provision may continue to evolve, Financial Professionals should work with clients who might otherwise consider dropping or reducing coverage until they are certain their long-term goals are covered.

Financial Professionals will also want to remind clients that, to pay for these tax cuts, Congress came close to weighing reductions in deductible 401ks. With retirement savings being so small, often referred to as The Retirement Crisis, those changes were averted. However, it drives home the point for clients to continue to be self-sufficient.

Corporate Tax Changes

One of the main goals of the Tax Bill is to increase job opportunities by decreasing corporate tax rates. Prior law set corporate tax rates from 15% to 35%.

The Tax Bill now reduces the corporate income tax rate to 21% (the lowest Federal corporate tax rate since 1939), beginning on January 1, 2018. This change does not sunset after 2025. The change is permanent, at least until the next time the Tax Code changes.

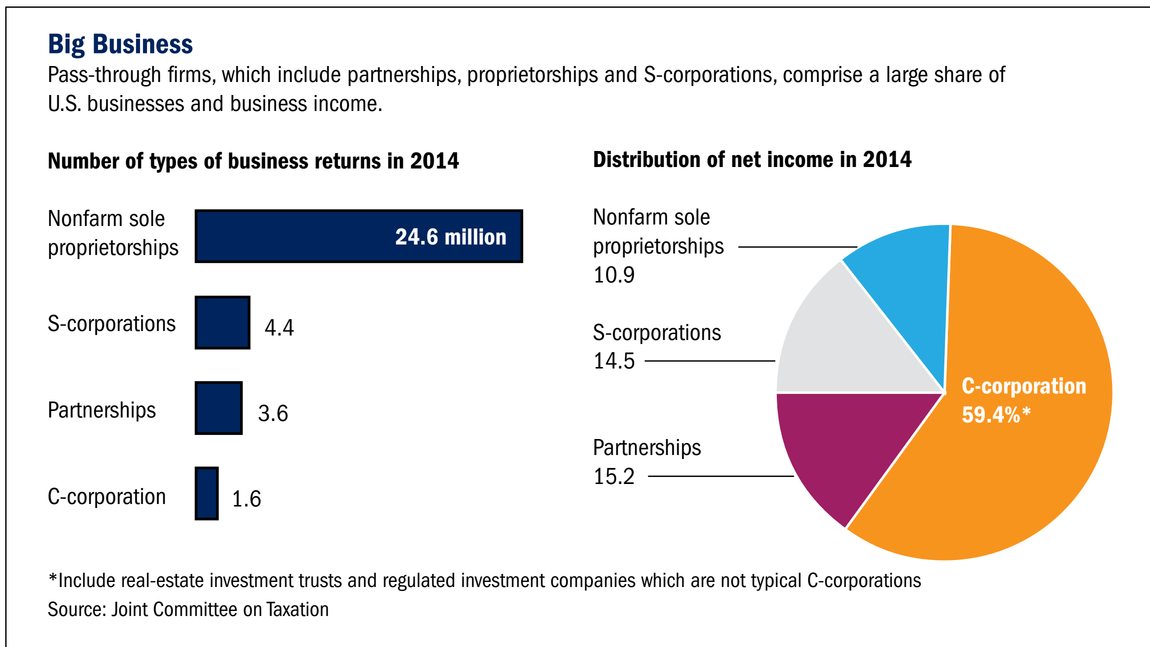
In addition, the Corporate AMT is repealed. The previous AMT rate was 20%, but many tax preference items that would typically serve as corporate income tax deductions were pulled back into taxable income, potentially raising the tax liability for certain businesses. A portion of Life Insurance death benefits were previously subject to the Corporate AMT, and that preference item is also eliminated with the entire Corporate AMT.

Planning Tips: For clients' businesses that are incorporated with net income over $50,000, the new lower tax rate could offer tax relief – leaving more of their profits to be allocated to other assets such as Key Person and/or Executive Benefit programs such Non-Qualified Executive Benefits and the permanent funding of buy-sell arrangements. The rate differentials may drive more interest into Split Dollar plans. Financial Professionals should be talking with clients about permanent cash value life insurance as a way to both help plan for these needs and build cash values for other retirement needs.

Plans that involve life insurance premium payments by corporate employers should be reviewed because of the lower corporate bracket and the repeal of the Corporate AMT. Additionally, life insurance death benefits received by a C Corporation may be even more efficient due to the repeal of the Corporate AMT. This may influence on the decision-making process regarding who is the owner of life insurance policies that are to fund buy-sell arrangements. Some C Corporations might weigh their level of coverage with the repeal of the AMT, but Financial Professionals should look at long term needs before adjusting death benefits.

Previously buy-sell arrangements, where there were numerous owners, avoided stock redemption approaches in part because of the Corporate AMT. Instead business owners often turned to trusteed cross-purchase agreements. With the elimination of the Corporate AMT it may be worth re-examining the use or redemption arrangements.

In addition to C Corporation planning, pass through entities and sole proprietorships make up the majority of actual operating businesses, although not the majority of income. For planning with these entities, see the next section.



Pass Through Entity Changes and Planning Opportunities

The new Tax Bill offers some substantial changes that will benefit may small businesses that are taxed as pass-through entities. These include companies such as S Corporations, Partnerships, LLC's that elect pass through status, and sole proprietorships. The Bill allows taxpayers to deduct 20% of their pass-through income from their taxes. Although the press has frequently called this a 20% rule, it's actual a fairly involved calculation that involves also looking at each owner's W-2 income and their basis in each entity. The caps on the 20% deduction are limited by 50% of an owner's W-2 income or 25% of their tax basis.

Additionally, there are threshold limits for Professional Service firms as to the amount of income the business can report and still be eligible for the 20% deduction to apply. The new Tax Bill allows the 20% deduction on taxable income from pass-through companies owned by Professional Service providers on incomes up to $157,500 (single filers) and $315,000 (joint filers). Incomes over that level are not eligible. These limits prevent some higher earning service firms like doctors, lawyers, Financial Professionals or professional athletes from taking full advantage of the change. Engineers and architects are carved out and treated akin to business owners. It also provides some guardrails that prevent owners/partners/LLC members from recharacterizing wage income as business profit, to obtain the benefit of the pass-through deduction. A last-minute addition to the Tax Bill included some tax cuts applicable to LLC's that hold large amounts of depreciable property like real estate.

Planning Tips: there are several important areas that Financial Professionals will want to discuss with their clients who own pass-through entities.

- With more available cash on hand, pass through entities may want to use the additional funds for key person and executive compensation plans. The rate differentials may drive more interest into Split Dollar plans for key employees. Executive Bonus plans should still continue to be popular. The cuts will also help to fund business continuation planning.
- Even though only 8 years of tax relief, it allows for a maximum funded 5 or 7 pay accumulation policy.

- As pass through entities receive more available cash on hand, small business owners may look to purchase life insurance policies as a means in which to max fund individually-owned cash value/accumulation contracts on a tax preferred basis, and supplement their own retirement income.
- Financial Professionals should also look at their own, in-force, book of business. Additional contributions into existing policies could potentially lead to higher IRR's on both cash value and death benefit amounts in both scenarios.
- There was considerable discussion among lobbying groups and Congress that the 20% deduction wasn't sufficient to bring pass through entities on par with C Corporations. At the same time, these income deductions for pass through entities will expire at the end of 2025 while the C Corporate changes remain permanent.
  - Financial Professionals will want to discuss with their clients whether it makes sense to convert their entity from a pass through to a C Corporation. In doing so they'll need to weigh whether the costs, accounting changes and possible tax implications associated with the conversion are appropriate for your client's entity. There remains the risk that a future Congress could reverse the law.
  - Alternatively, Financial Professionals may want to discuss with their pass-through entity owners whether it makes sense to break the entity into multiple entities to take advantage of certain rules around real estate and other depreciable property, which might now enjoy accelerated deductions. This comes with additional planning and tax consequences so the splitting of entities should be weighed.

Estate and Gift Tax Law Changes

For obvious reasons, the majority of the focus from the Tax Bill have been on the tax rate cuts for both corporations and individuals. However, one item to not overlook are changes for the gift, estate and generation skipping tax exemptions.

The 2018 exemption amount was slated to be $5,600,000 (and $11,200,000 for married couples). The new Tax Bill will double the exemption to $11,200,000 per individual (and $22,400,000 for married couples). Although full repeal of the estate tax was proposed, the approved version instead will have a sunset provision after 2025 and revert to an indexed for inflation adjusted level of approximately $6,200,000.

These changes also apply to gift taxes and the gift tax exemption. There are no tax rate changes and other provisions, such as portability, remain.

Planning Tips: The lifetime exemption increase is temporarily doubled for eight years, and then scheduled to return to today's exemption amounts (adjusted for inflation) beginning in 2026. It is estimated that in 2026 the threshold would be approximately $6,200,000 per individual. In recent history, the estate tax only affected a small portion of America's population, and now will affect an even smaller group consisting of only the ultra-high net worth families.

Whether the estate tax is repealed after 2025 or re-implemented in part or in full, clients need to be made aware of the importance of planning. As the following chart indicates, change is only the sure thing when it comes to estate tax.

With the uncertainty in the estate tax environment, now might be an appropriate time to help clients engage in planning for any asset and estate transfer, aiming for flexibility. Planning with life insurance is still valuable to address possible state estate taxes, needed liquidity at death for business purposes, charitable giving and wealth transfer to family members. Knowing that these provisions sunset after 2025, care should be taken before reducing any death benefit face amounts or canceling any existing coverage.

Remember too that with the temporary increase, high net worth clients can also increase their gifting. For the right client, this increased amount could be a windfall. This will need to be a client by client discussion. Although clients might be able to double their gifts, these gifts will not receive a step-up in basis at death. For that reason, the ideal gifts may be cash or highly appreciating assets where it's desirable to remove growth from a client's estate.

Clients can also use discounting techniques – which remain highly effective in today's low interest rate environment – to further leverage the amounts that are transferred out of their estate to younger generations under the temporarily expanded gift exemption.

Because these increased exemptions will expire, all other planning - including current insurance, trusts, credit shelter and portability planning, etc. should be looked and and possibly remain in place.

An increasingly common technique, even among clients without taxable estates, is to use death benefit/protection focused life insurance contracts as a form of wealth transfer to younger generations. These life insurance policies are often designed of strong Internal Rates of Return (IRR) at a client's life expectancy to help leverage premium dollars. Clients can use the gifts to pay premiums on life insurance policies either through the gift itself (cash gifts) or by gifting income generating property to create a regular income stream for life insurance premiums.

Year	Legislation
1797-1802	To cover expenses, a Federal Stamp Tax is imposed on certain estates. It remains in place until 1802.
1815	Congress debates an estate tax to finance the War of 1812.
1864-1870	Estate tax is introduced due to budgetary pressures from the Civil War.
1898-1902	After several attempts by Congress, an estate tax is introduced on estates greater than or equal to $10,000.
1916	Estate tax is levied on estates over $50,000.
1924	Estate tax is increased to 40%. Gift tax is added.
1926	Gift tax is repealed.
1932	Gift tax is reinstated.
1934	Estate tax increases to 60% for estates over $10 million.
1948-1953	Various bills increase and decrease estate and gift taxes. Estate taxes rise as high as 77% and gift taxes rise as high as 57.75%.
1954	Most employer qualified plans are exempted from estate taxes. By 1982, this exclusion is reduced to only $100,000. It is repealed in 1988 and a 15% excise tax is imposed, which remains in place until 1997.
1976	Major legislation combines estate and gift taxes into a unified rate.
1986	Generation-skipping taxes at a flat 55% rate are imposed.
2001	Congress votes to gradually decrease estate taxes by increasing exemption equivalents from $1 million to $3.5 million over time, and by decreasing maximum marginal tax brackets from 55% to 35%.
2010	Estate taxes are repealed for one year.
2011	Rates are set at a $5,000,000 exemption equivalent and a 35% top rate through 2012.
2013	All estate, gift and generation-skipping transfer tax rules are changed to reflect a maximum tax rate of 40% and an exemption equivalent amount of $5,250,000. Exemption amounts will continue to be indexed for inflation.

Effect of Taxes at the Life Insurance Carrier Level

During the debate on the various House and Senate tax bills there were a variety of provisions related to life insurance carriers. For decades, a tax has existed under IRC §848 which requires the amortization of carrier income regardless as to when received in relation to the acquisition of the policy. In fact, there has been a debate as to whether the cash values in a life insurance policy might be lower than they would have been in the absence of a deferred acquisition cost (DAC) tax load. The new DAC provision extend the amortization period for specified policy acquisition costs from 120 months to 180 months and changes the discount rates applied to annuity and life insurance contracts from 1.75 and 7.7 percent to 2.09 and 9.20 percent, respectively.

Whether this additional tax will influence carrier pricing, remains to be seen and may vary widely among carriers. There is some sense that the reduction in the corporate tax rate and the elimination of the Corporate AMT, could offset the negative effect of this increased tax at some carriers.

If you have any questions, contact AXA Advanced Markets.

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