TCJA Post-Mortem Update for Individuals:

Success or Failure for the U.S. Economy?

Introduction

The 2017 Tax Cuts and Jobs Act (TCJA) brought sweeping changes to the tax laws for individuals. Some people have felt the impact of the tax law changes more than others, however.

Here are some key observations — including possible direct and indirect effects of the TCJA — as the April 15 deadline for filing your 2019 personal tax return approaches.

Table of Contents

Section 1: Summary of Major Tax Law Changes

Summary of Major TCJA Changes

Most of the TCJA provisions that affect individuals are in effect only through 2025. But Congress could pass legislation to extend them, make them permanent — or modify them, depending on the results of the 2020 election. Key changes that are temporary include:

Reduced individual tax rates. The TCJA reduces most individual income tax rates. Under current law, there are seven tax brackets: 10%, 12%, 22%, 24%, 32%, 35% and 37%. The law also provides new thresholds for each bracket and reduces the number of individuals who are subject to the alternative minimum tax (AMT).

Limitations on certain itemized deductions. The TCJA limits deductions for:

- State and local taxes to $10,000 annually, and
- Interest paid on home acquisition and home equity debt taken out after December 15, 2017.

Current tax law also suspends itemized deductions for miscellaneous expenses, including unreimbursed business expenses, which were previously subject to a 2%-of-adjust gross income (AGI) floor. However, there's also good news for people with higher income: The TCJA suspends the itemized deduction phase-out rule.

Decreased threshold for medical expense deductions. The TCJA reduced the AGI threshold for itemized medical expense deductions from 10% to 7.5% for 2017 and 2018. Fortunately, this provision has been extended through 2020 under the Taxpayer Certainty and Disaster Tax Relief Act, which passed at the end of 2019.

Summary of Major TCJA Changes

Expanded standard deduction. Though the TCJA eliminates personal and dependency exemptions, it nearly doubles the standard deduction to $12,000 for single filers, $18,000 for heads of household and $24,000 for joint filers. Through 2025, the standard deduction is adjusted annually for inflation.

For 2019, the inflation-adjusted deduction is $12,200 for single filers, $18,350 for heads of household and $24,400 for joint filers. For 2020, the inflation-adjusted deduction is $12,400 for single filers, $18,650 for heads of household and $24,800 for joint filers.

As a result of these changes and other limitations on itemized deductions, fewer taxpayers itemized deductions in 2018. Specifically, a recent study by the Tax Policy Center, an independent research organization, estimates that the percentage of households who itemize deductions on their tax returns fell from 26% in 2017 to 11% in 2018. Similar outcomes are expected for the 2019 tax year.

Increased federal estate and gift tax exemption. The TCJA doubled the unified estate and gift tax exemption from $5 million to $10 million, indexed annually for inflation. For 2019, the exemption is $11.4 million ($22.8 million for married couples). For 2020, the exemption is $11.58 million ($23.16 million for married couples). As a result of the increased lifetime exemption, fewer estates will pay federal estate tax.

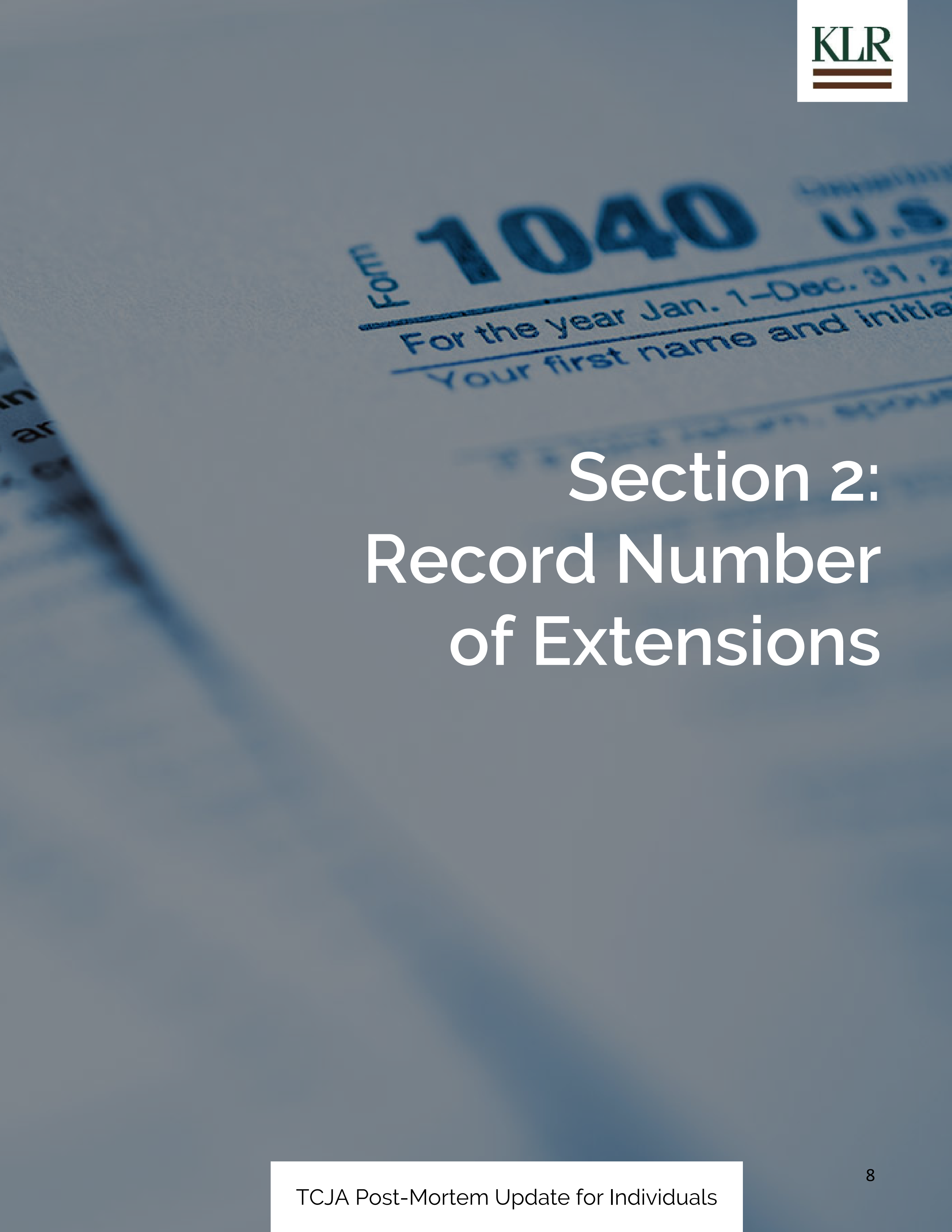
Additionally, the IRS published clawback guidance in 2019, confirming that large gifts made under current law won't lose the tax benefit of the higher exclusion level once it decreases. Depending on the results of the 2020 election, the lifetime exemption could return to pre-TCJA levels *before* 2026, along with other possible changes to the federal estate and gift tax rules. As a result, many proactive taxpayers are jumping on this tax-saving opportunity now — before it expires.

Provisions affecting small business owners. People who report income from so-called “pass-through” entities (such as sole proprietorships, partnerships, limited liability companies and S corporations) on their individual tax returns also may benefit from the pro-business provisions of the TCJA. This includes the deduction of up to 20% on qualified business income (QBI). However, some small business owners were adversely affected by the TCJA’s limit on deductible business losses.

Provisions affecting parents and other caregivers. The TCJA doubles the child tax credit to $2,000 per eligible child and increases income phase-out thresholds. A new $500 credit may be available for other qualified dependents, including a qualifying 17- or 18-year-old, a full-time student under age 24, a disabled child of any age, and other nonchild relatives

Parents also should note a recent amendment to the kiddie tax rules. Under the TCJA, most of a child’s unearned income was taxed based on the rates for trusts and estates. This change was generally unfavorable to people affected by the kiddie tax. However, under the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019, the kiddie tax provisions of the TCJA were retroactively repealed. Therefore, the old kiddie tax regime is reinstated and most of a child’s unearned income is, once again, based on the parents’ marginal tax rate.

Some TCJA changes that affect individuals are *permanent*, unless Congress passes legislation to repeal or suspend them. For example, under current tax law, changes to the rules for Section 529 plans allow you to take distributions to pay for elementary or secondary school tuition and make tax-free rollovers to ABLE accounts. In addition, people who pay alimony under post-2018 divorce agreements can no longer deduct those payments, and retirement savers can no longer reverse ill-fated Roth IRA conversions.



Section 2: Record Number of Extensions

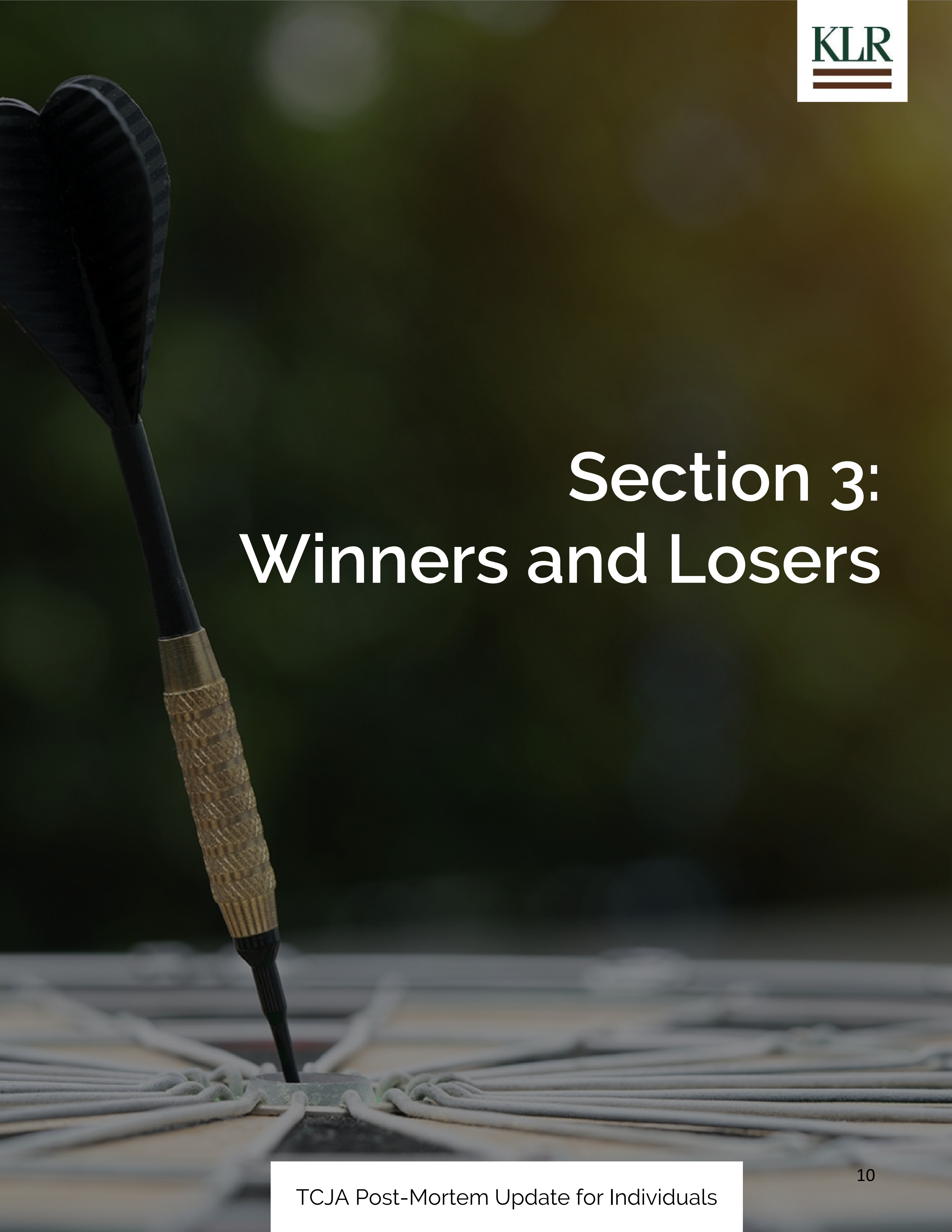
Record Number of Extensions

Given the scope and complexity of the changes under the TCJA, a record number of individuals filed for extensions for the 2018 tax year. Before the TCJA went into effect, about 10 million taxpayers extended their tax returns each year. In 2018, that number increased 50% to roughly 15 million taxpayers, according to the IRS.

Remember: Filing an extension gives you six more months (until October 15) to file your individual tax return — but it doesn't give you an extra six months to pay your tax obligation.

Many people opted to take advantage of the automatic six-month extension to give themselves extra time to understand the tax law changes, collect supporting documentation and await additional guidance from the IRS. In fact, in 2020, the IRS is continuing to issue guidance to clarify various provisions of the TCJA.

To complicate matters, a *new* batch of tax law changes were introduced by a spending package that was signed into law in December 2019. These include various extender provisions under the Taxpayer Certainty and Disaster Tax Relief Act and provisions to encourage retirement savings under the SECURE Act. These changes may add to the confusion about current tax law — and prompt many taxpayers to extend their 2019 returns.



Section 3: Winners and Losers

Winners and Losers

When the TCJA was signed into law, the Trump administration estimated that its corporate tax cuts would translate into a $4,000 raise for the average household. Did the TCJA live up to this claim in 2018?

The Tax Policy Center studied the effects of the TCJA for 2018 and found that:

- On average, U.S. households paid roughly $1,600 less in federal income taxes in 2018 than they would have under prior law. Split between 24 paychecks in a year, the average savings translates into about $67 per paycheck.
- About 65% of households paid *less* in federal income taxes under the TCJA than they would have under prior law. The average tax cut among those who came out ahead under the TCJA was about $2,200.
- Only 6% of household paid more in federal income taxes under the TCJA than they would have under prior law. The average tax increase for this group was $2,800.

The Tax Policy Center reports that the effects of the TCJA in 2018 varied based on household income levels. For example, households earning less than $25,000 saved an average of $40 under the TCJA, which equates to 0.3% of after-tax income. However, households earning more than $733,000 (the top 1% of all taxpayers) saved an average of $33,000 under the TCJA, which equates to 2.2% of after-tax income. The biggest savers were households with income between $308,000 and $733,000; they saved an average of $11,200 or 3.4% of after-tax income.

Other factors that affect a household's tax situation include sources of income, marital status, family composition and applicable state tax laws. Situations that tend to result in unfavorable tax outcomes under the TCJA include:

- Individuals with expensive homes in high-tax states who claim substantial itemized deductions for mortgage interest, home equity interest and State and local taxes,
- Parents with children older than age 16 who don't qualify for the expanded child tax credit and are no longer eligible for dependency exemptions, and
- Owners of small businesses (such as startups) that incur substantial losses that are limited under current tax law.

Conversely, examples of situations tend to result in *positive* tax outcomes under the TCJA include:

- Households that didn't itemize deductions under prior law and now benefit from the increased standard deduction,
- Parents of children who are age 16 or younger and qualify for the expanded child tax credit,
- Owners of profitable pass-through entities that are eligible for the QBI deduction, and
- People who inherited significant estates (valued between $5 million and $10 million) that escaped a major tax hit thanks to the expanded federal estate and gift tax exemption.

Multiple TCJA provisions may come into play for your household. Determining how the TCJA affects your federal income tax bill requires a comprehensive analysis of your situation.

Section 4: Perceptions Gap

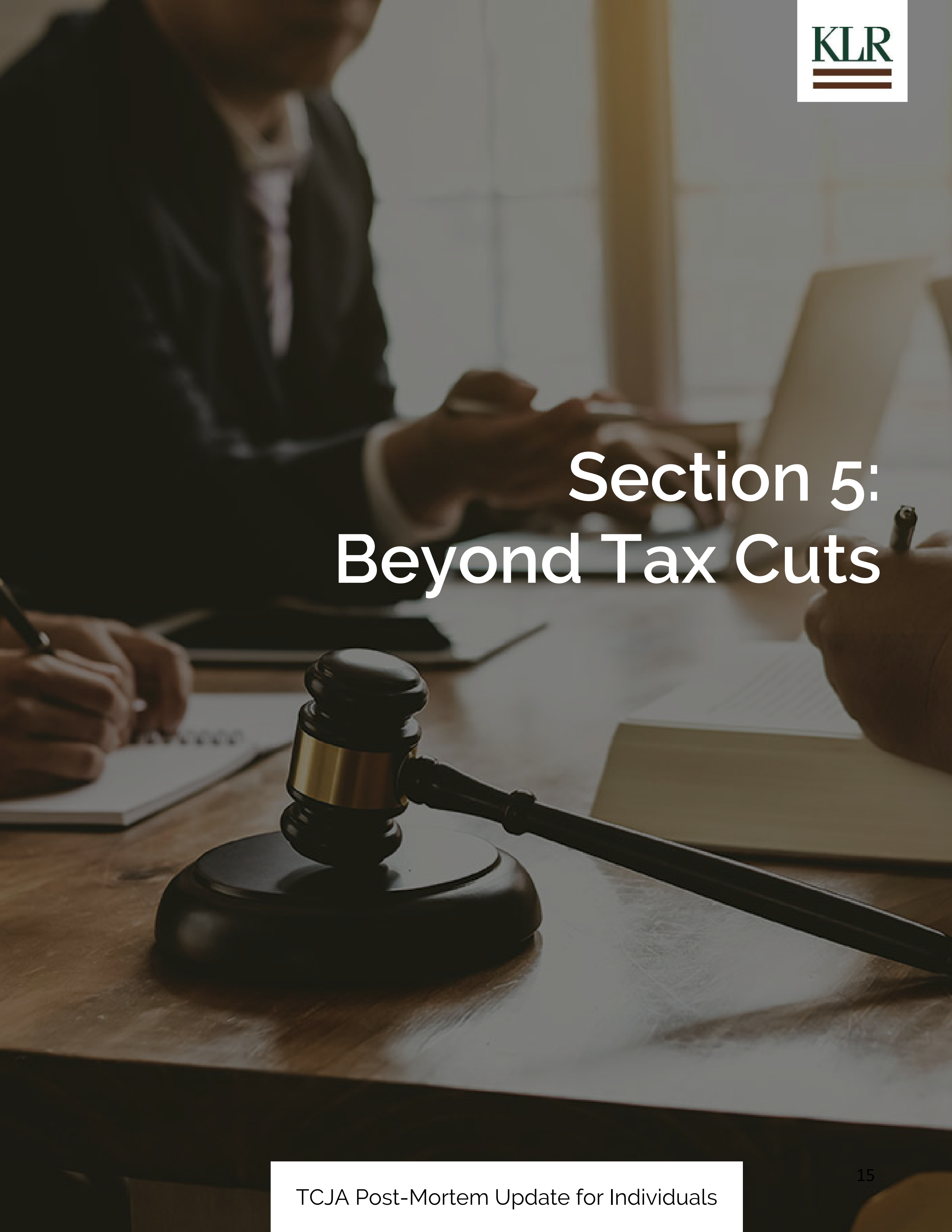
Perceptions Gap

Roughly two-thirds of households received a tax cut under the TCJA. But far fewer people *believe* they benefited from the law. A poll conducted by the *New York Times* at the end of last tax season found that only 40% of taxpayers thought they got a tax cut in 2018

The disparity is greater at higher income levels. For example, 32% of households with income below $30,000 got a tax cut, and 30% believe it. However, 90% of households with income above $100,000 got a tax cut, but only 46% believe it.

One reason for the disparity is that refunds were down in 2018, because many people didn't pay enough throughout the year in withholdings or quarterly estimates to cover their tax liability. The IRS estimates that roughly 2.7 million *fewer* people received tax refunds in 2018 than in 2017. People who received a smaller-than-expected refund or who had to write a check to the U.S. Treasury on Tax Day probably weren't happy with their tax situation last April.

In addition, the percentage change in the average household's tax bill is relatively small, compared to the major tax breaks received by businesses under the TCJA. As a result, many people think the TCJA is designed primarily to benefit businesses, not individuals.



Section 5: Beyond Tax Cuts

Beyond Tax Cuts

Though the *direct* effects of the TCJA generally don't amount to a noticeable change for many people, the *indirect* effects of the law may extend beyond a lower federal income tax bill.

For example, people with retirement savings plans likely benefited from corporate tax cuts, which have generally increased annual returns on retirement plan investments. Retirement plan funds, like 401(k)s or IRAs, often are invested in U.S. stocks, and the market has performed well since the TCJA was enacted. Specifically, the S&P 500 grew approximately 21% from $2,674 in December 2017 to $3,231 in December 2019.

Part of this growth can be attributed to business tax cuts that have generated extra cash to pursue value-added growth opportunities. In addition, some incremental cash flow from business tax cuts may trickle down to individuals as higher wages, enhanced benefits and bonuses, new job opportunities and training for higher paid positions.

In December 2019, the White House published an article, "Two Years On, Tax Cuts Continue Boosting the United States Economy." It reports on the financial effects of tax reform, including the following changes that affect individuals:

- Wages have increased, especially for blue collar workers. Blue collar wages rose at a 3.0% annual rate from January 2017 through November 2019. The annual growth rate was 2.4% from July 2009 through December 2016. The nominal wage growth for the lowest wage earners has been 10.6% since the TCJA was signed.
- Unemployment rates dropped to 3.5% in 2019, the lowest rate in a half-century. Likewise, job openings are at historic highs.
- Investment into qualified opportunity zones (QOZs) has helped revitalize low-income communities.

However, many changes appear consistent with pre-TCJA trends. In 2019, the *New York Times* reported that June marked the tenth anniversary of the end of the Great Recession, and workers are benefiting from "the longest economic expansion on record." So, the uptick in economic condition began long before the TCJA was signed.

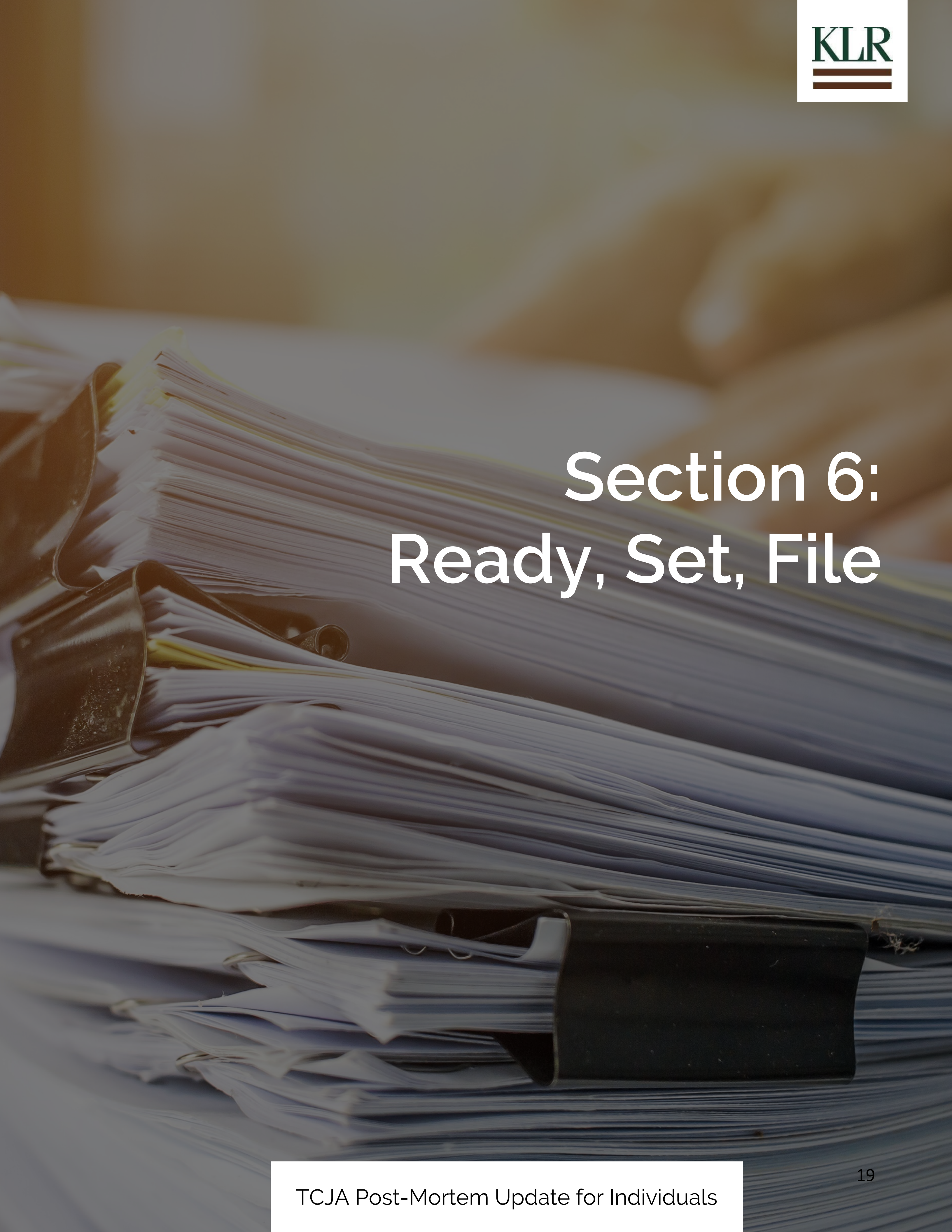
It's also hard to find a *direct* correlation between these changes and the TCJA. For example, increasing wages also could be linked to job market competition and recent changes to the wage-and-pay regulations at the state and federal levels.

The American Enterprise Institute, a public policy think tank, reports that gross domestic product (GDP) grew at an annualized rate of 2.5% in the 18 months *after* the TCJA was passed. But the GDP growth rate was 2.6% in the 18 months *prior* to the TCJA. These statistics suggest that, over the short run, there hasn't been much change in macroeconomic growth before and after the TCJA.

There have also been warning signs that economic growth may be slowing, despite tax reform legislation. In September 2019, Federal Reserve Chairman Jay Powell pointed to the "continued softness" in business investment and declining output in the manufacturing sector as reasons for lowering the federal funds rate.

Finally, the tax cuts under the TCJA have reportedly added to the federal deficit over the last two years. The Congressional Budget Office (CBO) expects the primary federal deficit to increase $1.3 trillion over 10 years and the overall debt (counting interest payments) to increase by $1.9 trillion.

The mounting federal deficit can't be attributed solely to the TCJA, however. Other factors, such as government spending and the balance of global trade, also may be at play.



Section 6: Ready, Set, File

Ready, Set, File

2019 is the second year that most of the TCJA provisions are in effect for individual taxpayers. Most analysts agree that this isn't enough time to fully evaluate the effects of tax reform on individual taxpayers. It will take several years to study the full effects — and by then, many of the provisions that affect individuals will have expired, unless Congress extends them

As you file your 2019 income tax return, it's important to review the lessons learned in 2018 and factor in additional changes to the tax law made in 2019. In some cases, there may be good reasons to file an extension for 2019 or an amended return for prior tax years. .

Right for You?

LET'S TALK

Our tax professionals can help you take advantage of current tax breaks — while they last — and discuss opportunities to plan for the 2020 tax year.

Contact our tax team to set up a meeting to brainstorm financial planning strategies to help you succeed in the future.

ABOUT THE AUTHOR

Laura H. Yalanis, CPA, MST is a Partner, Director of Tax Services at KLR and joined the firm in 2005. She has been providing tax advisory services to closely held, medium sized and publicly held businesses, including construction industry clients. She assists clients with a variety of tax issues and has extension experience with companies in the hotel, restaurant and hospitality related industries.

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