Tax Reform: The Biggest Changes

New rules could affect income taxes, deductions, college savings, and more.

By Fidelity Investments
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Key takeaways

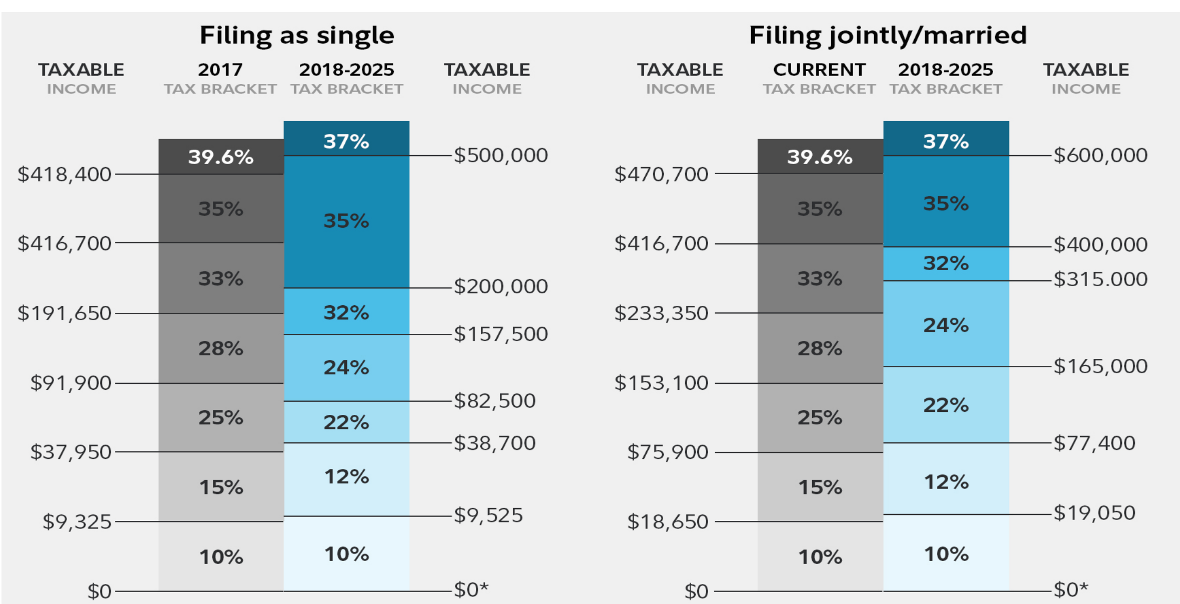
✓ Individuals should consult with a tax professional to understand how changes to the tax code may impact their strategies for deductions, estate planning, education funding, and small-business income.

The President signed the sweeping tax reform bill, ushering in a broad range of changes including new rules for income tax rates and deductions, college savings incentives, estate planning, and corporate taxes. Now may be time to consider what is in the new law, and what it may mean for you.

Adjusted individual tax brackets and lower rates

The new tax code will reduce several of the marginal income tax rates (see chart). Those new tax brackets, and the other changes to the individual tax code would all be temporary - Congress would need to act or the rules would revert to current law after December 31, 2025.

Adjusted tax brackets



Tax reform will combine the personal exemption and standard deduction into a single higher standard deduction, which will be indexed to inflation. The child tax credit increases and there will be a new dependent tax credit.

	Rules for 2017	New rules for 2018-2025
Standard deduction	$6,350 per individual $12,700 married couple filing jointly (MFJ)	$12,000 per individual $24,000 married couple filing jointly
Child tax credit	$1,000	$2,000
Senior citizens (over age 65)	Additional $1,500 (individuals) Additional $2,500 (Couple MFJ, both spouses over age 65)	Additional $1,600 (single) Additional $2,600 (Couple MFJ, both spouses over age 65)
Dependent tax credit	None	$500 per non-child dependent

The new law will change the balance between itemized and standard deductions. Higher standard deductions mean it will make sense for fewer people to itemize deductions - so charitable gifts, medical expenses, home mortgage interest, and other itemized deductions, will all face a higher threshold before they become useful.

In addition, the new law directly changes or limits a large number of deductions and credits. Here is a look at how a few of the most popular deductions will change.

Deductions and credits	Rules for 2017	New rules
Mortgage interest	$1 million primary, and second homes and some home equity debt	Limited to $750,000 of mortgage debt for primary and secondary homes. This provision would be applicable for taxable years after December 31, 2017 and beginning before January 1, 2026, when the limit would return to $1,000,000. Eliminates deduction for interest on home equity loans until taxable years beginning after December 31, 2025.
State and local tax deduction	Deductible	Capped at $10,000 for sales and state and local property taxes or sales and state and local income taxes
Medical expense deduction	Expenses greater than 10% of AGI are deductible	Expenses greater than 7.5% of AGI could be deducted for 2017 and 2018.
Adoption expense tax credit	Expenses up to $13,570 qualify	No change

Retirement savings incentives unaffected

The new rules do not call for changes to existing retirement savings incentives, preserving the favorable tax treatment and contribution limits for 401(k)s, IRAs, and other retirement savings accounts. The law also left the rules for health savings accounts intact.

The law does end the Roth IRA recharacterization option starting in 2018, but 2017 recharacterizations will be permitted. Recharacterization allowed taxpayers to undo a Roth IRA conversion for a limited time, and was often useful if the value of the converted investments fell.

Temporary increase in federal estate tax exemption

The law will roughly double the federal estate tax exemption to $11 million per person ($22 million per couple). That limit will be indexed to inflation, but would expire and revert back to current law after 2025.

Beneficiaries will still get a step up in basis, meaning there would be no capital gains tax due on inherited assets at the time of the transfer, and the cost basis - the value used to compute tax liability - would be reset to the price at that date.

It is important to note that state level estate tax exemptions are often much lower than the federal level and are unaffected by this law. In addition, the temporary nature of the higher limit means that if you have an estate plan, you should proceed carefully before making any changes.

"While a further increase in the estate tax exemption will help some families avoid this tax at the federal level," says Kevin Ruth, head of wealth planning and personal trust at Fidelity, "it remains important for all households to have a current estate plan that helps ensure their wishes are carried out and reduces the cost of transferring assets as part of an estate."

Changes to the alternative minimum tax (AMT)

The AMT was designed to prevent high-income individuals from avoiding income tax by piling up deductions. It is essentially a parallel method for calculating your income tax liability.

New corporate tax rate and pass-through tax rate

Corporate tax rates will be cut to 21% beginning in 2018. That tax cut is not scheduled to expire.

Pass-through businesses, businesses structured as sole proprietorships, partnerships, and S-corporations, will be taxed at individual tax rates, but will be able to deduct 20% of income. To prevent high-income individuals from taking advantage of this deduction, it would only be available to couples filing jointly with incomes below $315,000. For income above that level, the rules are complex but it appears that certain kinds of businesses might still be eligible for a partial deduction.

The plan would let businesses fully expense new equipment right away, but the provision would eventually expire.

529 plans become more flexible

The tax legislation allows up to $10,000 per year in 529 savings plan assets to be used for education expenses for grades K–12, in addition to college and post-graduate study. It will also temporarily increase the contribution limits to ABLE accounts under certain circumstances.

The bottom line

There are a few things you may want to consider in light of the new legislation, and may want to consult with a tax professional about, so you can be prepared.

• **Rethink your mortgages and deductions:** If you have traditionally made charitable gifts or benefited from the mortgage interest or state and local tax deduction, you want to look at how the new standard deduction will impact you. If it no longer makes sense to deduct these expenses, you may want to rethink your mortgage or giving strategy. The imposition of a cap on state and local tax deductions may also impact where some people choose to live in retirement.

• **Look at your education expenses:** 529 plans have offered tax benefits for families saving for college. So if you have kids or grandkids you should consider how these accounts factor into your savings plans. With the new rules, families that pay for private elementary or high schools may also want to consider the benefits of these accounts. Some offer state income tax deductions and preferential treatment for investment gains, which can help to manage the cost of education.

• **Estate tax:** Even in the absence of tax reform, it makes sense to periodically review your estate plan. If the estate tax limit changes are relevant to your plan, it may make even more sense to revisit your strategy. You may want to meet with your estate planning attorney.

• **Small-business income:** If you own a small business, you may want to reconsider how you structure your income and the form of your enterprise. Depending on the size and particulars of your business, you may want to consider the benefits of incorporation or the restructuring of pass-through organizations. Consult with an expert in small-business taxation.

• **Timing corporate expenses:** With new rules in place temporarily for expensing capital equipment purchases, business owners may want to review their capital expenditure plans.