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TAX REFORM

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Below is a summary of the provisions of the new tax reform law that are most likely to impact Big "I" members. This document is not meant to be an exhaustive analysis of all provisions of the law that may impact independent insurance agents and brokers, as the law's effect will vary depending on the individual circumstances of tax filers. Big "I" members are encouraged to consult with their accountants, lawyers and other relevant professionals related to tax and estate planning based on their individual circumstances. In addition, the changes that the law imposes are extensive, and how the reforms in their entirety ultimately impact the decision-making and subsequent tax liability of businesses and individuals remains to be seen. Finally, the Internal Revenue Service (IRS) will be issuing future regulations and guidance in 2018 and beyond (not considered here) to implement certain provisions of law, which may impact tax planning for businesses and individuals moving forward.

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Businesses

Subchapter C Corporations

The centerpiece of the new law is a large cut to the corporate tax rate. Section 13001 of the new law imposes a permanent flat tax on business organized as Subchapter C Corporations of 21% and fully repeals the corporate alternative minimum tax (AMT). However, a corporation that receives a dividend from another corporation can only deduct 50% of the dividend. Previously 70% of the dividend was deductible. If the company receiving the dividend owns more than 20% but less than 80% of the company paying the dividend, the deduction is 65% of the dividend received. Previously 80% was deductible. Approximately one-third of Big "I" members are C Corporations. [1]

Pass-Through Entities

Of note for the two-thirds of Big "I" members who are organized as Subchapter S Corporations, Partnerships and Sole Proprietorships the new law enacts several changes on pass-through entities.

20% Deduction[2]

Under the new law income from pass-through businesses will be taxed at the new relevant individual rates. (See individual section of this document for more details.) In addition to the reductions in the individual tax rates, the new law creates a special deduction for some pass-through entities. Section 11011 of the law adds a new section to Part VI of Subchapter B of Chapter 1 of the Tax Code (26 U.S.C. §199A) giving a 20% deduction on "qualified business income" (QBI) subject to certain limitations. The 20% deduction is taken on QBI as reported on Schedule C, and not used to compute Adjusted Gross Income (AGI) or to reduce overall taxable income. The deduction is available to both nonitemizers and itemizers. Trusts that are owners or shareholders in a pass-through business may also use the deduction.

As it relates to insurance agencies and brokerages whether the deduction can be used will depend on the annual taxable income of the owner or shareholder seeking to use the deduction. Owners or shareholders of "specified services businesses" organized as pass-through entities are limited in their utilization of the deduction. Most if not all activities related to the sale and servicing of insurance are likely to fall under the definition of "specified service businesses"[3] in the Tax Code. Insurance agency owners or shareholders can utilize the deduction as follows:

- An agency owner or shareholder may deduct 20% of their QBI if their annual taxable income does not exceed $315,000 for joint filers and $157,500 for single filers in 2018.

[1] The 2016 IIABA Agency Universe Study found that roughly two-thirds of respondents were organized as pass-through entities, while the remaining one-third were organized as C Corporations.

[2] Examples in this Section are adapted from Section B "Treatment of Business Income of Individuals, Trusts, and Estates" of the Conference Report for H.R. 1 (pages 20-40).

[3] The new tax law defines "specified services activities" as any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, the performance of services that consist of investing and investment management, trading, or dealing in securities, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.

For example, if Joe Agency Owner and his spouse earn $200,000 in taxable income, $100,000 of which is attributable to Joe's insurance agency, the permitted deduction is 20% of $100,000, or $20,000.

- For an agency owner or shareholder with annual taxable income between $315,000 and $415,000 (joint), and between $157,500 and $207,500 (single) the 20% deduction of their QBI is phased out and cannot exceed 50% of applicable employee wages paid, or 25% of applicable wages plus 2.5% of capital assets (e.g. tangible property purchased for the business), whichever is greater. In calculating the deduction, the percentage of income in the phase out range is used when determining the "applicable percentage" deduction the taxpayer is entitled to so that the deduction will always be less than 20%. To put it another way, when computing QBI the taxpayer takes into account only the "applicable percentage" of qualified items of income, gain, deduction, or loss, and of allowable W-2 wages.

For example, Jane Agency Owner who files as an individual has taxable income of $200,000, of which $100,000 is business income from her insurance agency. Jane pays wages of $50,000 to employees, and Jane did not put any property into service for her agency during the tax year. First, Jane must determine her applicable percentage because her income is in the $50,000 individual phase out range. Her applicable percentage is 15% (1-($200,000-$157,500)/$50,000). Then to determine permitted applicable QBI Jane calculates 15% of $100,000, or $15,000. Next, to determine the employee wage limitation Jane calculates 15% of $50,000, or $7,500. So, Jane calculates the deduction by taking the lesser of 20% of $100,000 or 50% of $7,500. Therefore, Jane's deduction is $3,750 (i.e. 50% of $7,500).

- An agency owner or shareholder with annual taxable income above $415,000 (joint) and $207,500 (single) cannot utilize the 20% deduction.

The above income thresholds are indexed for inflation; however, the provision is scheduled to sunset on December 31, 2025.

QBI is determined for each trade or business of the taxpayer. For any taxable year, QBI means the net total of qualified items of income, gain, deduction, and loss with respect to the trade or business of the taxpayer to the extent such items are included or allowed in the determination of taxable business income for the year. QBI also does not include any amount paid by an S Corporation that is treated as reasonable compensation of the taxpayer. Finally, qualified items do not include specified investment-related income, deductions, or loss.

For example, if in a taxable year, an insurance agency has $100,000 of ordinary income from sales, and makes an expenditure of $25,000 that is required to be amortized over five years under applicable tax rules, QBI is $100,000 minus $5,000, or $95,000.

The deduction is reduced if there is a loss, but the relevant portion of the loss can be carried forward.

For example, if Joe Insurance Agency Owner has QBI of $20,000 from Agency A and a loss of $50,000 from Agency B in Year 1. Joe is not permitted a deduction for Year 1 and has a carryover qualified business loss of $30,000 to Year 2. In Year 2, Joe has QBI of $20,000 from Agency A and $50,000 from

Excess Business Losses

Section 11012 of the law adds new language to the end of Section 461 of the Tax Code (26 U.S.C. §461) that disallows "excess business losses" of non-corporate taxpayers. Any loss that is disallowed shall be treated as a net operating loss carryover to the following taxable year. This is the first time that active losses from pass-through businesses will be limited; however, the provision is scheduled to expire in 2025.

The new law generally defines the term "excess business loss" as "the aggregate deductions of the taxpayer for the taxable year which are attributable to trades or businesses of such taxpayer" over the sum of "the aggregate gross income or gain of such taxpayer for the taxable year which is attributed to such trades or businesses" plus $250,000 for individual filers and $500,000 for joint filers, adjusted annually for inflation. In other words, in 2018 owners and shareholders of pass-through businesses cannot deduct more than $250,000 (individual) and $500,000 (joint) of active business losses.

In the case of Partnerships and S Corporations the provision is applied at the partner/shareholder level to each partner/shareholder's allowable/pro-rata share of the items of income, gain, deduction, or loss of the partnership or S Corporation for the taxable year.

Conversions of S Corporations to C Corporations

Finally, Section 13543 of the new law makes some preferential changes for S Corporations wishing to convert to C Corporations. The law amends Section 481 of the Tax Code so that if an S Corporation converts to a C Corporation before 2020 any income adjustments that arise from such a conversion would be considered ratably over a six-year period. The law continues to allow for cash distributions from a converted S Corporation to be generally treated as tax-free to the extent of the S Corporation's accumulated adjustment accounts (AAA), however, the law also amends Section 1371 of the Tax Code so that after one year, such distributions would be partially taxable in proportion to the remaining AAA compared to accumulated earnings and profits.[4]

[4] Big "I" members considering converting from an S Corporation to a C Corporation, or vice versa, who also anticipate selling their agency in the near future should be aware of Section 1374 of the Tax Code. Under Section 1374, a C Corporation that converts into an S Corporation may be liable for built-in-gain (BIG) tax if the corporation's assets at the time of conversion are sold during a five-year statutory recognition period. The new tax law did not make any changes to Section 1374.

Selected Business Deductions, Exclusions and Credits

The new law makes amendments and changes to certain deductions, exclusions and credits related to businesses. Unless otherwise noted the changes are permanent.

- **Health Care**: The new law does not impact the ability of employees to use pre-tax dollars to pay their contribution toward employer health plans nor does it change the deductibility of employer costs related to health plans.

- **Interest Deduction:** The new law amends Section 163(j) of the Tax Code to limit the deduction of net interest to 30% (previously 50%) of earnings before interest, taxes, depreciation, amortization, and depletion between 2018 and 2021. Starting in 2022, the earning limit considers depreciation, amortization, and depletion. However, businesses earning under $25 million are exempt from this limit.

- **Meals and Entertainment Deduction**: In 2017, employers were permitted to deduct 50% of the costs of business-related meals and entertainment expenses. Now, no deduction is permitted for entertainment expenses, however the 50% deduction for meals is retained.

- **Medical and Family Leave**: For 2018 and 2019, the law would create a tax credit ranging between 12.5% and 25% for wages paid to an employee on family and medical leave. Employers must offer a qualifying paid leave program to take advantage of the deduction.

- **Section 179 Expensing:** Section 179 of the Tax Code allows certain small businesses to take a depreciation deduction for certain assets (capital expenditures) in one year, rather than depreciating them over a longer period. Deductions under Section 179 are now limited to $1 million instead of $500,0000 and phased out at $2.5 million, instead of $2 million, indexed for inflation. Separate rules apply for the depreciation of business vehicles under Section 179. The law also expands the types of property that qualifies for expensing. Qualified property generally includes tangible, depreciable, personal property which is acquired for use in the active conduct of a trade or business; and is now expanded to include improvements to non-residential real property (i.e. roofs, heating, security systems).

- **Temporary 100% Expensing**: The law amends Section 168(k) of the Tax Code by allowing immediate expensing of 100% of new equipment placed in service between September 27, 2017 and the end of 2022. For property placed in service after December 31, 2022 expensing is decreased on a pro rata basis by 20% per year (i.e. 80% in 2023, 60% in 2024, 40% in 2025, 20% in 2026).

- **Transportation Deduction**: As of January 1, 2018, employers can no longer deduct the cost or partial cost of transportation (i.e. parking and transit passes) for employees. Employees can still use pre-tax income to pay for parking or public transportation.

- **Tuition Reimbursement**: The new law does not make any changes to the deductibility of tuition reimbursement benefits provided by employers. Employers can still contribute up to $5,250 a year to an employee's tuition for qualifying education and continuing education programs, and it remains tax free to the employee.

Individuals

As of January 1, new tax rates and rules are in effect for every taxpayer in the U.S. While some of these changes may not be immediately noticeable, the IRS is in the process of drafting and issuing new withholding rules, as well as various regulations to implement the changes to the tax code. As a result, individuals will start seeing changes to their tax levels soon into 2018, and when taxes are filed in the first part of 2019. However, all provisions related to the individual tax code are scheduled to expire on December 31, 2025. This means that absent Congressional action to extend, change, or otherwise make permanent the changes, the law will revert to what was in effect for the 2017 tax year, adjusted for inflation on January 1, 2026.

New Tax Brackets

2017 Brackets		2017 Rates	2018 Rates	2018 Brackets	
Single	$0 to $9,325	10%	10%	$0 to $9,525	Single
Joint	$0 to $18,650			$0 to $19,050	Joint
HOH	$0 to $13,350			$0 to $13,600	HOH
Single	$9,325 to $37,950	15%	12%	$9,525 to $38,700	Single
Joint	$18,650 to $75,900			$19,050 to $77,400	Joint
HOH	$13,350 to $50,800			$13,600 to $51,800	HOH
Single	$37,950 to $91,900	25%	22%	$38,700 to $82,500	Single
Joint	$75,900 to $153,100			$77,400 to $165,000	Joint
HOH	$50,800 to $131,200			$51,800 to $82,500	HOH
Single	$91,900 to $191,650	28%	24%	$82,500 to $157,500	Single
Joint	$153,100 to $233,350			$165,000 to $315,000	Joint
HOH	$131,200 to $212,500			$82,500 to $157,500	HOH
Single	$191,650 to $416,700	33%	32%	$157,500 to $200,000	Single
Joint	$233,350 to $416,700			$315,000 to $400,000	Joint
HOH	$212,500 to $416,700			$157,500 to $200,000	HOH
Single	$416,700 to $418,400	35%	35%	$200,000 to $500,000	Single
Joint	$416,700 to $470,700			$400,000 to $600,000	Joint
HOH	$416,700 to $444,500			$200,000 to $500,000	HOH
Single	Over $418,400	39.6%	37%	Over $500,000	Single
Joint	Over $470,700			Over $600,000	Joint
HOH	Over $444,550			Over $500,000	HOH

The new law amends the inflationary measure that the individual income tax brackets are indexed to. The indexing of income tax brackets (and other income thresholds) was formerly pegged to the Consumer Price Index for All Urban Consumers (CPI-U). It is now indexed to the Chained Consumer Price Index for All Urban Consumers (C-CPI-U). The C-CPI-U is a slower growing measure of inflation than the CPI-U.

Capital Gains

The new law does not change the rate at which long-term capital gains are taxed. The tax rates for long-term capital gains will remain the same as 2017 (e.g. 0%, 15%, and 20%), however, the income levels at which the respective rates apply is now different.

For 2018, the zero rate is applied in the case of income no more than $51,700 for individuals and heads of household, and $77,200 in the case of those filing jointly. The 15% rate applies in the case of income no more than $452,400 for individuals and heads of household, and $479,000 in the case of those filing jointly. For filers with incomes above these levels the rate is 20%. The income thresholds are indexed to the C-CPI-U.

Short-term capital gains will continue to be taxed at the relevant individual rates, and the 3.8% Affordable Care Act (ACA) surtax on net investment income for higher income brackets will continue to apply.

Alternative Minimum Tax (AMT)

Despite efforts to eliminate the AMT, the AMT for individuals is retained in the new law. However, the amount of income exempted from AMT and the phase-out thresholds are increased substantially. The AMT is imposed when it exceeds a filer's regular tax. The AMT equals 26% of income above the relevant exemption amount up to $175,000 and 28% on any excess income. The exemption amounts for 2018 are $109,400 for joint filers and $70,300 for single filers. The income exemption is phased out for joint filers at $1 million and $500,000 for single filers.

*For example, if a single filer earns $150,000 in taxable income in 2018, and after deductions, credits and exclusions the individual's tax liability is less than $20,722 [($150,000 - $70,300) * 26% = $20,722] he or she would be subject to the AMT.*

While retaining the AMT will still force some filers to calculate their tax liability under alternative systems, due to the increase in the exemption and threshold levels for the AMT, the repeal of personal exemptions, and limitations on many deductions, the AMT is expected to impact far fewer individuals.

Selected Individual Deductions, Exclusions and Credits

The new law makes substantial amendments to, and also eliminates various deductions, exclusions and credits.

- **Standard Deduction:** The standard deduction reduces a filer's taxable income by the deduction amount and is taken by filers who do not itemize their taxes. The new law nearly doubles the level of the standard deduction. For 2018 the standard deduction is $12,000 for a single filer, $18,000 for head of household, and $24,000 for joint filers. The deduction is indexed for inflation. Also, like the changes to the individual rates, the changes to the standard deduction are scheduled to expire on December 31, 2025. The new law leaves intact the additional standard deduction for filers who are over 65 or blind, allowing them to claim an additional $1,250 for individual returns and $2,500 for joint returns (if applicable to both individuals).

- **Personal Exemption:** The new law eliminates the personal exemption until 2026. For 2017, a filer up to certain income levels could deduct from their income $4,050 for every taxpayer and most dependents claimed on their return.

- **Alimony:** Alimony and spousal support payments are taxable by the individual who receives them. The new law, however, removes the tax deduction for the payor for any alimony contained in divorce or separation agreements finalized after December 31, 2018.

- **Charitable Deduction:** The new law slightly increases the size of the charitable deduction, allowing taxpayers to deduct qualifying charitable contributions up to 60% of their AGI through December 31, 2025.

- **Child / Dependent Tax Credit**: The new law increases the child tax credit from $1,000 to $2,000 per child under age 17. Up to $1,400 of the tax credit is refundable for lower income families in 2018. Thereafter, the $1,400 is indexed for inflation. Joint filers with AGI of up to $400,000, and all other filers with AGI of up to $200,000 annually can take the full credit. Thereafter the allowable tax credit is reduced by $50 for each $1,000 of AGI above the $400,000 and $200,000 limits. The tax credit as well as the thresholds are not adjusted for inflation. Also under the new law, a $500 tax credit is available for other dependents (e.g. elderly live in parent). The changes to the child/dependent tax credit expire on December 31, 2025.

- **Disaster Costs**: In 2017 you could itemize deductions for certain property and casualty losses not covered by insurance due to events like fires and floods if they were more than 10% of your AGI. The new law limits the deduction to losses that are incurred from a federally declared disaster between January 1, 2018 and December 31, 2025.

- **Estate and Gift Tax:** The excess value of large estates is subject to a 40% excise tax upon the death of the owner(s) of said estate. In 2017 the first $5.6 million of an individual decedent's estate was exempt from the estate tax. The new law doubles this exemption for 2018 to $11.2 million. The threshold is indexed for inflation and is twice as large for married couples (e.g. $22.4 million). The increase to the estate tax threshold expires after 2025.

- **Medical Expenses**: The new law includes a temporary change in the deduction of medical expenses. In 2018 and 2019 medical expenses can be deducted if they are above 7.5% of the filers AGI. After 2019 this percentage of AGI reverts to 10%.

- **Miscellaneous Itemized Deduction**: The new law removes the deduction for miscellaneous items through December 31, 2025. In 2017, to the extent that certain items--including unreimbursed job expenses, business liability insurance premiums, licensing and regulatory fees, tax preparation fees, hobby expenses, and in some cases legal fees--exceed 2% of AGI they were deductible.

- **Mortgage Interest**: For any home loans taken out in 2017 or before, interest for loan balances of up to $1 million can be deducted, including if the loan is refinanced after 2018. For any home loans taken between January 1, 2018 and December 31, 2025 interest for loan balances up to $750,000 can be deducted. Finally, the new law eliminates the deduction for all current and future home equity loans through the end of 2025.

- **State and Local Taxes**: Taxpayers can deduct the amount they pay in state and local sales, income, and/or property tax. However, the new law caps the total aggregate amount of the deduction at $10,000. The $10,000 cap applies whether you file as a single filer or jointly. For married couples filing separately it is capped at $5,000 per person. The cap does not apply to taxes that are paid or accrued in carrying on a trade or business. This provision expires after 2025.

- **529 and ABLE Accounts**: The new law expands the expenses that a 529 college savings account can be used for to include private elementary and secondary education costs of up to $10,000 a year. Moreover, amounts from 529 plans can be rolled over into an ABLE account, if the beneficiary or a member of the beneficiary's family receives a designation of disability. However, the rollover would count toward the $14,000 annual limit on the ABLE account. ABLE beneficiaries can also contribute their own earnings to an ABLE account once the $14,000 annual gift limit is reached.

Other Provisions of Note

The Individual Mandate

Under the ACA most people were required to carry health insurance and the failure to do so subjects an individual taxpayer to a tax penalty of $695 or 2.5% of income, or a penalty of $2,085 or 2.5% of income for a family. Under the new tax law, the penalty no longer applies starting in 2019, however, there is no federal prohibition on a State enacting a penalty similar to the ACA.

Taxation of Insurance Companies

The new law makes some specific changes to how certain types of property and casualty and life insurance companies are taxed that could impact the price of certain insurance products. For example, the new law modifies the reserve discounting rules applicable to property and casualty insurance companies. For life insurance companies, the law changes how companies must calculate reserve deductions as well as several other deductions. The law also repeals the small life insurance company deduction, and changes the rules for taxation of pre-1984 policyholder distributions and for computing reserves when a company changes its accounting procedures, among other things.

Finally, the law eliminates a provision of the tax code under which some foreign-based insurers and reinsurers, and foreign-based affiliates of U.S. insurers and reinsurers, used "affiliate reinsurance" to lower their tax liability. Affiliate reinsurance had been utilized by both property and casualty and life insurance companies.

Retirement Accounts

While the possibility of limiting the ability of some or all individuals to contribute to retirement accounts on a pre-tax basis was discussed during the tax reform debate, the new law does not change the way employees (or employers) contribute funds to 401(k)s or similar employer-offered retirement accounts. The new law will, however, allow terminating employees to repay an outstanding retirement plan loan by the date their tax return must be filed instead of a 60-day period. The law also permits penalty-free distributions from retirement savings plans (up to a limit of $100,000) for people in disaster areas (as declared by the President) in 2016 and 2017.

For those individuals who convert traditional Individual Retirement Accounts (IRAs) to Roth IRAs the final law restricts recharacterization of IRA contributions. Thus, conversions from a traditional IRA to a Roth IRA are still permitted, but recharacterization cannot be used to unwind a Roth conversion.

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