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Guide to Income Taxes:

Overview of Federal and State Income Taxation

Income taxes are a major source of revenue for both federal and state governments alike. In 2017, the Tax Cuts and Jobs Act was enacted, which made sweeping changes to individual income taxes on the federal level. On the state level, income tax laws vary tremendously depending on the state in question. On one end of the spectrum, certain states tax residents on both ordinary income and income from long-term capital gains with rates that can exceed 13%. At the other end, a handful of states do not tax their residents on income at all.

This guide is intended to give a general overview of frequently asked questions on federal and state income taxes and is current as of ***January 2018.***

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1. What were the biggest changes to federal income tax law enacted by the Tax Cuts and Jobs Act of 2017?

On December 20, 2017, the Tax Cuts and Jobs Act was signed into law. This law made significant changes to U.S. taxation, particularly in the areas of individual income taxation, estate, gift and GST taxation, and corporate taxation.

With respect to income taxes, the Tax Cuts and Jobs Act temporarily decreases individual tax rates, including a reduction of the top rate from 39.6% to 37%. The seven current brackets are as follows: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The 37% rate applies to individuals and married couples who earn more than $500,000 and $600,000, respectively (both thresholds indexed for inflation). The top rate for long-term capital gains and qualified dividends remains the same at 20%.

Under the new law, the standard deduction is increased to $24,000 for married filing jointly, $12,000 for single filers, and $18,000 for heads of household (indexed for inflation). The deduction for personal exemptions for dependents is repealed.

The child tax credit is doubled to $2,000 per qualifying child under age 17, with a maximum refundable amount per child (if the credit reduces the tax below zero) of $1,400. An additional credit of $500 for each dependent that is not a qualifying child (e.g., elderly parent, special needs adult child, etc.) is also available. The phase-out threshold for these credits is increased to $400,000 for joint filers (up from $110,000) and $200,000 for single filers (up from $75,000).

The vast majority of itemized deductions available to individuals were repealed or modified under the Act. Specifically, the following deductions were repealed:

- Personal casualty and theft losses
- Moving expenses (except for active-duty members of US military changing duty stations)
- Tax preparation expenses
- Alimony payments after 12/31/18 (while not deductible, payee no longer reports these payments as income)

Regarding charitable contributions, the AGI limitation against which such a deduction for charitable **cash** contributions may be applied is increased to 60% (from the current 50%).

State and local taxes are allowed as a deduction only when paid or accrued in carrying on a trade or business. As an exception to this general rule, a taxpayer may claim these taxes as an itemized deduction of up to $10,000 ($5,000 for married taxpayer filing a separate return).

A taxpayer may also deduct interest on indebtedness up to $750,000 (for married filing jointly) to acquire qualifying real estate for loans taken out after December 15, 2017. For loan existing before that date, the current $1,000,000 indebtedness limitation still applies. Interest on home equity borrowing is no longer deductible.

For the remaining itemized deductions, the current phase-out/cap on itemized deductions for high-income taxpayers (the so-called “Pease Amendment limit”) is repealed.

These provisions related to individual income taxes under the Tax Cuts and Jobs Act are slated to expire at the end of 2025. At that time, the law will revert to the law that was in effect in 2017.

2. What other taxes should high income earners be aware of?

A 3.8% tax on net investment income and a 0.9% Medicare surtax on earned income may be imposed on taxpayers who meet certain income thresholds. These taxes were included as part of the Affordable Care Act enacted in 2010 and were designated as “Medicare taxes,” although none of the revenue generated by these taxes is earmarked for Medicare or health care purposes.

Net Investment Income Tax

A 3.8% net investment income (NII) tax is imposed on taxpayer’s with “investment income” whose adjusted gross income exceeds the following thresholds:

- $250,000 for married couples and qualifying widow(er)
- $200,000 for unmarried individuals and head of households;
- $125,000 for married taxpayers filing separately

PLANNING NOTE

These threshold numbers **are not** indexed for inflation, which means that more and more taxpayers could be subject to this net investment income tax as their income grows. Also of note, this tax is not imposed on individuals who are treated as non-resident aliens for U.S. income tax purposes.

For individuals, the 3.8% NII tax is imposed on the **lesser of:**

(i) the taxpayer's "net investment income" or

(ii) the taxpayer's modified adjusted gross income (MAGI) *in excess* of the threshold amounts discussed above.

For example, assume a single taxpayer has a MAGI of $220,000 and net investment income of $100,000. Because the taxpayer's MAGI is over her threshold amount of $200,000, she is subject to the NII tax. However, the excess of the taxpayer's MAGI over her threshold amount is $20,000. Since the NII tax applies to the **lesser of** the excess over the taxpayer's MAGI threshold (i.e. $20,000) or her total amount of net investment income (i.e. $100,000), this taxpayer's NII tax liability is $760 ($20,000 x 3.8%).

"Investment income" for the purposes of this tax generally consists of income from interest, dividends, annuities, royalties, rents and gains attributable to the disposition of property (other than property in a trade or business). Investment income does not include distributions from a qualified retirement plan and generally excludes income generated as part of an active trade or business. Additionally, amounts received from a non-MEC life insurance policy as a withdrawal (up to basis) or a loan should also be excluded from the definition of investment income.

For trusts and estates, the NII tax is on the **lesser of:**

(i) undistributed net investment income or

(ii) the excess of AGI over the dollar amount at which the highest income tax bracket applicable to a trust or estate begins.

The surcharge does not apply to nonresident aliens or to trusts that are devoted to charitable purposes or tax exempt. The tax also does not apply to trades or business conducted by a sole proprietor, partnership or S-corporation, although the tax may apply if the trade or business is either a passive activity with respect to the taxpayer or the trade or business consists of trading financial instruments or commodities.

Medicare Surtax

An additional 0.9% tax is imposed on wages and self-employment income when an individual's earned income is in excess of the threshold amounts discussed above for the net investment income tax.

To illustrate the applicability of this tax, assume Bob, a single taxpayer, has a salary of $300,000. The standard "Medicare tax" that applies to all employee-taxpayers is 1.45%, so the first $200,000 of Bob's wage income will be subject to the 1.45% Medicare tax. However, the remaining $100,000 of Bob's income (i.e., the amount that exceeds the $200,000 threshold for single taxpayers), will now be subject to a 2.35% Medicare tax (i.e., 1.45% + 0.9% additional tax).

For self-employed individuals, who pay both the employee and employer portion of the Medicare tax, their tax liability will increase to 3.8% (i.e., 2.9% + 0.9% additional tax) on income in excess of the threshold.

For married couples, even if each individual in the couple has wages or employment income less than the threshold amounts, the couple will still be subject to the 0.9% tax to the extent their combined incomes exceed the threshold.

PLANNING NOTE

The Tax Cuts and Jobs Act of 2017 did not impact the applicability of the net investment income tax or the Medicare surtax.

Similar to the net investment income tax, this Medicare surtax is not imposed on individuals who are treated as non-resident aliens for U.S. income tax purposes.

3. How do the 2017 income tax changes affect trusts and estates?

The Tax Cuts and Jobs Act decreased the rates for trusts and estates by decreasing the minimum tax bracket from 15% to 10% and decreasing the maximum tax bracket from 39.6% to 37%. The capital gains tax for trusts and estates that fall in the highest income tax bracket remains 20%.

Under the new law, there are four brackets (10%, 24%, 35%, 37%) instead of five. In contrast to the thresholds that apply to individual and married taxpayers before they fall into these higher tax pools, the income tax brackets for trust and estates are extremely condensed. For example, in 2018, once a trust or an estate has taxable income in excess of $12,500*, the top rate of 37% applies to ordinary income and taxable income in excess of $12,700 is subject to a top rate of 20% for long-term capital gains property.

Moreover, the 3.8% tax on net investment income also applies to estates and trusts, but the threshold is the dollar amount at which the highest tax bracket for these entities begins (e.g., $12,500 for 2018).

Consequently, the condensed income tax brackets for estates and trusts will result in many entities being subject to these additional taxes where their individual taxpayer beneficiaries (or grantors) may not.

PLANNING NOTE

The current income tax rates and brackets for trusts and estates are scheduled to expire at the end of 2025. In 2026 and beyond, the income tax rates for trusts and estate will revert to the rates under the American Taxpayer Relief Act of 2012 (i.e., the top tax bracket will increase from 37% to 39.6%).

4. Are federal income taxes likely to increase in the future?

Many of the changes made under the Tax Cuts and Jobs Act of 2017 that affect individual taxpayers are set to expire at the end of 2025. Consequently, many individuals could see their federal tax liability increase after 2025 when tax rates revert to the law in place in 2017 (e.g., top tax rate increases from 37% to 39.6%).

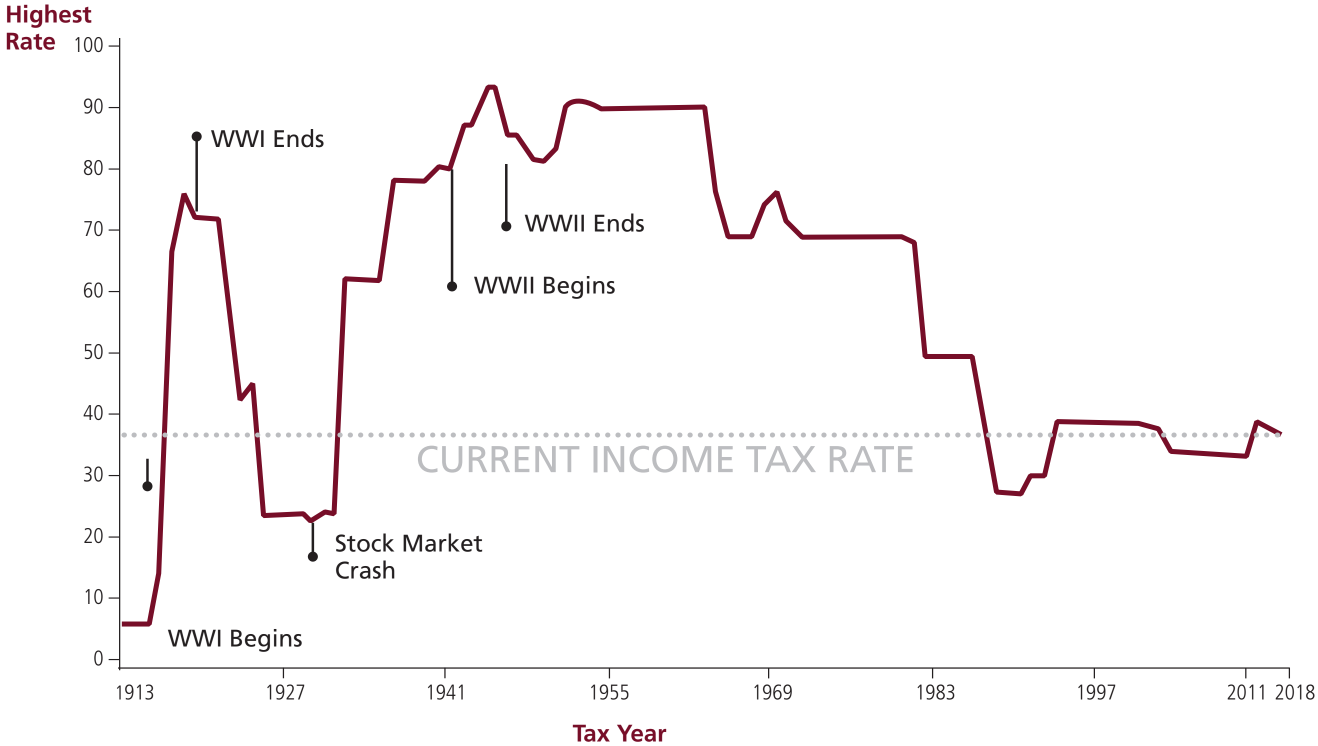
Additionally, when considering the future of income taxes, keep in mind:

- Congress has the authority to raise taxes at any time;
- Income tax revenue historically has been one of the ways that Congress collects money for the federal budget and to decrease the deficit;
- Despite various efforts to reduce the budget and the national deficit, spending and debt obligations continue to increase.

* This number is indexed for inflation; consequently, please refer to our "Fingertip Tax Guide" to check the applicable threshold for a given year.

For informational and educational purposes only, consider the following graph charting the historical income tax rates between 1913 and 2018.

History of the Income Tax



Source: IRS SOI Tax Stats Historical Table 23 data http://www.irs.gov/uac/SOI-Tax-Stats-Historical-Table-23

5. Which states impose their own income tax separate from the federal government and what are the differences between these states?

The imposition of state income tax varies widely between the states. Although an in-depth review of the income tax laws throughout the 50 states is beyond the scope of this guide, the following chart provides a helpful overview of the highest marginal and capital gains tax rates in each state. Keep in mind that different rules apply to different states and while some states might have low (or no) income taxes, they might have high property taxes or sales taxes to compensate for the lost revenue.

Moreover, many states exempt certain types of income (e.g., social security income, amounts received from IRAs or qualified plans) from tax. Before a client considers "forum shopping" to take advantage of income tax laws that are perceived to be more beneficial, it is important for the client to consult with competent tax advisors to determine how his or her particular sources of income and income needs are affected by state law.

STATE	TOP MARGINAL TAX RATE	TOP LONG-TERM CAPITAL GAINS RATE	OF INTEREST
Alabama	5.00%	5.00%	Some cities or counties also impose an income tax of 0.5% (on average)†
Alaska	None	None	No state income tax or sales tax (although some localities impose a sale and property tax)
Arizona	4.54%	4.54%	
Arkansas	6.90%	4.83%	Only 70% of long term capital gains are taxed (rate reflects this)
California	13.30%	13.30%	
Colorado	4.63% (Flat)	4.63%	
Connecticut	6.99%	6.99%	
Delaware	6.60%	6.60%	
Florida	None	None	
Georgia	6.00%	6.00%	
Hawaii	11.00%	7.25%	
Idaho	7.40%	7.40%	
Illinois	4.95% (Flat)	4.95%	Taxpayers in 2017 will pay a blended flat rate of 4.35% (reflects a July 2017 increase from 3.75% to 4.95%).
Indiana	3.23% (Flat)	3.23%	Some counties also impose an income tax of 1.16% (on average)†
Iowa	8.98%	8.98%	
Kansas	5.70%	5.70%	
Kentucky	6.00%	6.00%	Some counties also impose an income tax of 2.08% (on average)†
Louisiana	6.00%	6.00%	
Maine	7.15%	7.15%	
Maryland	5.75%	5.75%	Some counties also impose an income tax of 2.88% (on average)† Non-residents are subject to a special tax rate of 1.25% in addition to the state income tax rate
Massachusetts	5.10% (Flat)	5.10%	A 12% tax rate applies to short term capital gains and sale of collectibles
Michigan	4.25% (Flat)	4.25%	Some counties also impose an income tax of 1.75% (on average)†
Minnesota	9.85%	9.85%	
Mississippi	5.00%	5.00%	
Missouri	5.90%	5.90%	Some counties also impose an income tax of 0.005% (on average)†
Montana	6.90%	6.90%	
Nebraska	6.84%	6.84%	Additional income tax on high earners up to 0.438%
Nevada	None	None	

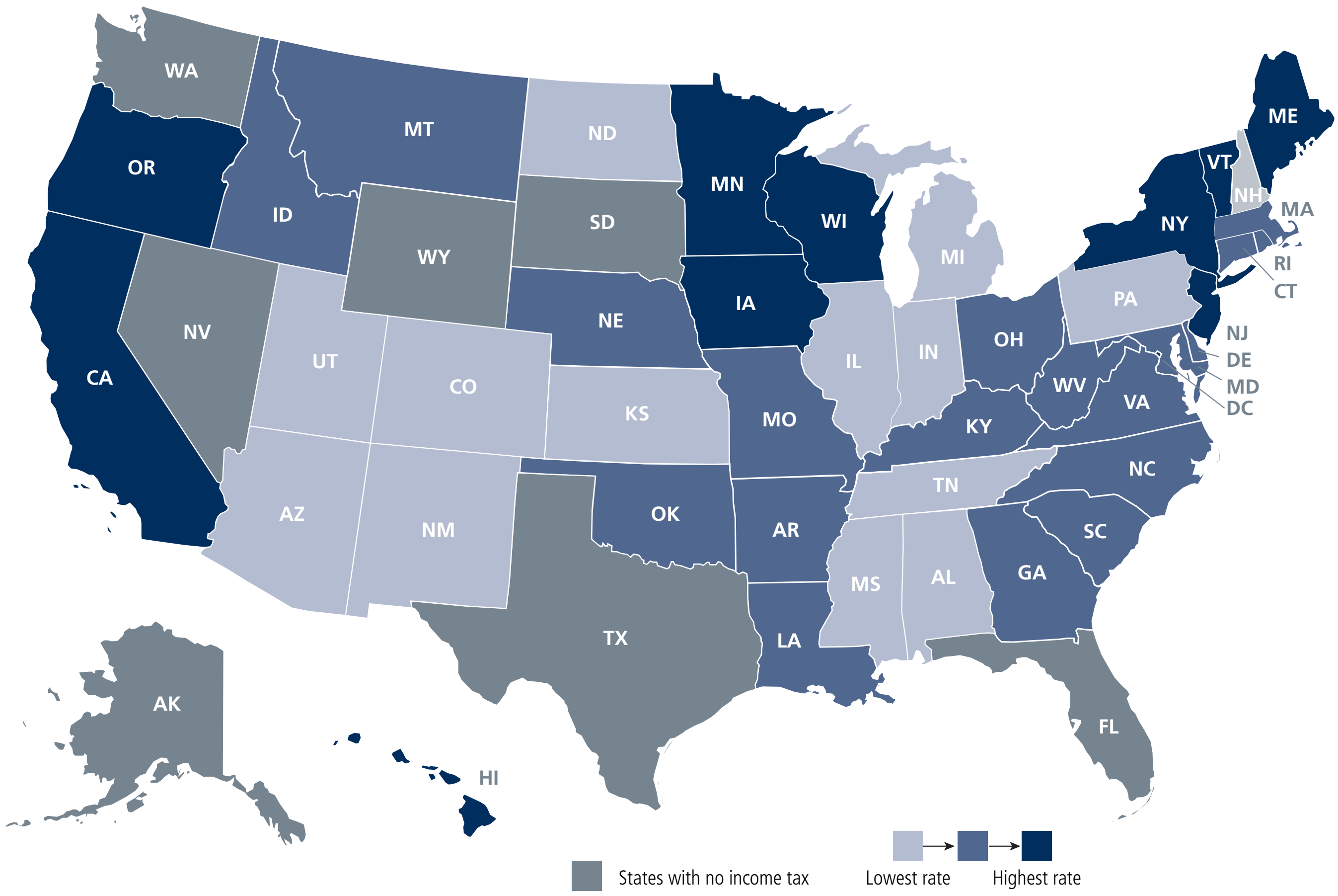
† Information from TaxFoundation.org.

STATE	TOP MARGINAL TAX RATE	TOP LONG-TERM CAPITAL GAINS RATE	OF INTEREST
New Hampshire	5.00% (Flat)	5.00%	Tax imposed applies to interest and dividend income only
New Jersey	8.97%	8.97%	
New Mexico	4.90%	4.90%	
New York	8.82%	8.82%	Some municipalities impose a local income ranging from 2.9-3.876%
North Carolina	5.499% (Flat)	5.499%	
North Dakota	2.90%	2.90%	
Ohio	4.99%	4.99%	Some counties also impose an income tax of 2.25% (on average)†
Oklahoma	5.00%	5.00%	
Oregon	9.90%	9.90%	Some counties also impose an income tax of 0.36% (on average)†
Pennsylvania	3.07% (Flat)	3.07%	Local sales tax imposed for Allegheny County (1%) and Philadelphia (2%). Philadelphia imposes a city tax of shorten to 3.91% for residents and shorten to 3.48% for non-residents
Rhode Island	5.99%	5.99%	
South Carolina	7.00%	3.92%	
South Dakota	None	None	
Tennessee	3.00% (Flat)	3.00%	Tax imposed applies to interest and dividend income only. Interest and dividend tax scheduled to be eliminated entirely for tax year 2022.
Texas	None	None	
Utah	5.00% (Flat)	5.00%	
Vermont	8.95%	8.95%	Allows some exclusion of capital gain income based on flat amount or % of income
Virginia	5.75%	5.75	
Washington	None	None	
Washington D.C.	8.95%	8.95%	
West Virginia	6.50%	6.50%	
Wisconsin	7.65%	5.36%	Only 70% of long term capital gains are taxed (rate reflects this)
Wyoming	None	None	

† Information from TaxFoundation.org.
Not valid without all pages.

State Income Tax Map

Refer to the map below for a quick snapshot of the states with highest top marginal tax bracket and no ordinary income tax.



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