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Generations Spring 2024 - Impending Expiration of Key Provisions of 2017 Tax Act

The Tax Cuts and Jobs Act (TCJA) was signed into law by President Donald Trump at the end of 2017. Among the changes made to the tax code by the TCJA were a reduction in the personal income tax rates, the reduction of the corporate tax rate from 35 percent to 21 percent, the doubling of the gift and estate tax exemption, and the limitation of the state and local tax deduction to $10,000. A number of these changes are set to expire effective January 1, 2026, unless Congress acts to extend their lifespan. Below we will discuss some of the more important changes that are set to expire.

Personal income tax rates

Prior to the TCJA, personal income tax rates were 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, 35 percent and 39.6 percent. Under the TCJA, the upper and lower limits for these tax brackets were altered and the marginal tax rates were reduced to the following rates: 10 percent, 12 percent, 22 percent, 24 percent, 32 percent, 35 percent and 37 percent. If Congress fails to extend the current reduced rates, personal income tax rates will return to their pre-TCJA levels as of January 1, 2026.

Gift and estate tax exemption

Whenever a taxpayer makes a gift to another person in excess of the annual gift tax exclusion ($18,000 per donee for 2024), the taxpayer must file a federal gift tax return and apply the amount of the taxable gift tax exclusion to that taxpayer's unified lifetime gift and estate tax exemption, known as the basic exclusion amount (BEA). Gifts between spouses who are U.S. citizens are not counted toward the BEA, even if they exceed the annual gift tax exclusion. If a taxpayer makes sufficient gifts over the years and exhausts the BEA, the taxpayer will be required to pay gift tax on any gifts going forward that exceed the annual gift tax exclusion. To the extent the taxpayer has not exhausted the full amount of the BEA upon their death, any assets passed by inheritance are counted toward what remains of the decedent's BEA, with any amount above the remaining BEA being subject to the federal estate tax (currently 40 percent).

Under the TCJA, the BEA was raised from $5.49 million for individuals and $10.98 million for couples to $11.18 million and $22.36 million, respectively. The BEA is adjusted annually for inflation and is currently $13.61 million per person. Without action by Congress, this increased BEA will return to the baseline exclusion of $5 million set in 2011, with adjustments for inflation. For married couples, the combined BEA will be $10 million, with adjustments for inflation. The IRS has finalized regulations to ensure that a taxpayer making a gift prior to January 1, 2026, will not recognize estate tax on death if the gift exceeds the BEA at the taxpayer's death but was below the BEA when the gift was made. This creates a "use it or lose it" scenario, forcing high-net-worth individuals to give serious consideration to making large taxable gifts prior to January 1, 2026. On that date, the lifetime gift and estate tax exemption will revert to its pre-TCJA level unless Congress acts.

Deduction for pass-through qualified business income

The TCJA reduced the corporate tax rate from 35 percent to 21 percent. This rate cut, unlike the other provisions discussed in this article, is not scheduled to sunset. While personal tax rates were also reduced, as discussed above, Congress wished to ensure that taxpayers were not unduly influenced by these changes to the tax code into selecting the corporate form over other pass-through business entities when deciding what form their business entity should take. To that end, the TCJA established a deduction against pass-through business income for qualified business income (the QBI deduction) derived by a taxpayer from an interest in a partnership, S corporation, sole proprietorship or certain types of trusts. The deduction is the lesser of (i) the combined qualified business income of the taxpayer or (ii) 20 percent of the taxpayer's taxable income less net capital gain. Combined QBI is defined as the sum of (i) a certain amount of income from each "qualified trade or business" carried on by the taxpayer and (ii) 20 percent of certain income from real estate investment trusts and qualified publicly traded partnerships. The amount derived from each qualified trade or business carried on by the taxpayer is the lesser of (i) 20 percent of QBI from each qualified trade or business or (ii) a certain percentage of (a) wages paid to employees of a qualified trade or business and (b) the unadjusted basis of depreciable assets connected to a qualified trade or business.

A qualified trade or business is any trade or business other than certain specified service trades or businesses (e.g., businesses in the health, law or accounting sectors) along with the trade or business of performing services as an employee. QBI is generally any taxable income connected to a U.S. trade or business, but it does not include income from net capital gain.

As with the other provisions of the TCJA discussed in this article, Congress will need to act to extend the QBI deduction in order to allow taxpayers to continue to enjoy this deduction after January 1, 2026.

Cap on mortgage loan interest deduction

Prior to the passage of the TCJA, homeowners could deduct interest expense arising from acquisition indebtedness secured by a first or second home. The aggregate amount of the acquisition indebtedness for which interest expense could be deducted was capped at $1 million. Additionally, interest expense on home equity loans up to $100,000 could be deducted as well. The TCJA reduced to $750,000 the cap on the amount of mortgage loans for which interest expenses could be deducted and eliminated the deductibility of interest expense for home equity loans. Following the expiration of this provision on December 31, 2025, both the original cap on acquisition indebtedness and the deduction for interest on up to $100,000 of home equity loans will be restored.

Miscellaneous itemized deductions

Prior to the TCJA, taxpayers were able to deduct miscellaneous itemized deductions if these deductions exceeded 2 percent of the taxpayer's adjusted gross income. With the passage of the TCJA, these deductions were suspended from December 31, 2017, to January 1, 2026, and currently they cannot be deducted at all. Assuming Congress does not act to continue their suspension beyond 2025, taxpayers will again be able to claim miscellaneous itemized deduction to the extent those deductions exceed 2 percent of their adjusted gross income.

Increase to charitable contributions deduction

Taxpayers currently may deduct charitable contributions to public charities from up to 60 percent of their adjusted gross income. For these purposes, adjusted gross income is a taxpayer's gross income less certain deductions but without taking into account other deductions (such as expenses arising from debt, investments, and state income and sales taxes) and net operating losses. However, after 2025, the percentage will return to 50 percent of adjusted gross income.

Alternative minimum tax

The alternative minimum tax (AMT) requires taxpayers making a certain amount of income (calculated by adding back certain specified deductions) to pay a greater amount of tax on this income than they might otherwise be required to pay under the standard tax regime. The taxpayer must calculate their alternative minimum taxable income, reduce this by a standard exemption amount (as of 2024, $85,700 for single filers, $133,300 for joint filers) and apply the AMT rates. These alternative rates are 26 percent on income below $232,600 and 28 percent on all income in excess of this threshold. If the taxpayer's tentative tax liability under the AMT regime is higher than their liability under the standard tax regime, they will be required to pay the AMT amount. The AMT exemptions phaseout for taxpayers with income above $609,350 for single filers and $1,218,700 for joint filers. The phaseout thresholds are substantially higher under the TCJA than they had previously been; in 2017, the phaseout for single filers was $120,700 and for joint filers it was $160,900. Both the phaseout thresholds and the exemption amounts will revert to their pre-TCJA baseline amounts, with adjustments for inflation, on January 1, 2026, unless Congress acts.

Qualified opportunity funds

The TCJA established a new form of tax incentive for investments made in businesses developing and operating in a qualified opportunity zone, a census tract that qualifies as a low-income community and has been designated a qualified opportunity zone by the Treasury secretary. Under the qualified opportunity zone regime, a taxpayer may defer gain from the sale or exchange of a capital asset or an asset used in a trade or business to an unrelated third party if the taxpayer invests the proceeds of the sale or exchange in a qualified opportunity fund during the 180-day period beginning on the date of the sale or exchange.

Any gain deferred under these rules must be included in income on the date that the taxpayer's interest in the qualified opportunity fund is sold or exchanged or on December 31, 2026, whichever is earlier. Under this rule, any taxpayer who invested in a qualified opportunity fund and still holds that interest on December 31, 2026, must recognize the gain that was deferred when the investment was originally made; gain may be reduced depending on the taxpayer's holding period. In addition, no new investments in qualified opportunity funds after December 31, 2026, will receive preferential tax treatment unless Congress acts to extend this incentive.

Cap on state and local tax deduction

The TCJA implemented a cap on the total amount of deductions a taxpayer can take for state and local taxes paid (e.g., state or city income taxes, real property taxes, personal property taxes), limiting this amount to $10,000. After December 31, 2025, this provision will no longer be effective and taxpayers may deduct state and local taxes above $10,000.

Conclusion

Whether or not these tax provisions will expire in 2026 is anyone's guess, but we may have a better sense after the November elections. If former President Trump wins reelection, he almost certainly will push hard for extension of his signature tax legislation. If President Joe Biden wins reelection, he might not follow the same course, although the president has signaled in recent appearances that he would be open to extending some of the TCJA provisions. Of course, all of this requires congressional action, and no one at this point knows which party will control either house of Congress after the elections or whether the Congress that emerges will be so divided that it cannot get much done. Stay tuned.

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