

The Washington Report

Holistic Planning Edition

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Tick-Tock... The Trump Tax Act is Expiring

MARKET TREND: While everyone is well aware of the sunseting (expiring) increases in the federal transfer tax exemptions, what's less well known is that other important tax cuts enacted under the 2017 Tax Cuts and Jobs Act (the "TCJA") will also sunset at the end of 2025. Assuming Congress does not enact legislation extending these tax cuts, individuals generally can expect to pay increased income tax beginning in 2026.

SYNOPSIS: Under current law, income tax rates will increase and the alternative minimum tax ("AMT") exemption and phaseout amounts will decrease at the end of 2025. The result is that many taxpayers will pay increased income tax beginning in 2026 either because they will be subject to higher rates or because they will be subject to the Alternative Minimum Tax ("AMT"). Taxpayers are well advised to prepare now.

TAKE AWAYS: Absent Congressional intervention, individuals should expect to pay increased income tax beginning in 2026. To prepare, they may want to consider their options, such as: (1) accelerating income (2) using life insurance products and/or (3) deferring losses. Taxpayers should consult tax professionals for advice tailored to their specific circumstances.

MAJOR REFERENCES: TCJA

1. **Background.** Republicans enacted the TCJA under a procedure known as budget reconciliation. This enabled them to avoid an expected filibuster by Senate Democrats, but it also required them to satisfy the Byrd Rule, which provides in part, that legislation enacted via budget reconciliation cannot increase the national deficit by more than a prescribed amount over a prescribed period—in this case, \$1.5 trillion over 10 years. To satisfy the Byrd Rule, Republicans drafted the TCJA so that many of its tax cuts sunset at the end of 2025. This article is the first of two in which we explore the tax cuts scheduled to sunset and the expected impact on taxpayers.
2. **Income tax rates will revert to pre-TCJA levels**

Background. The TCJA reduced the marginal tax rates applicable to ordinary income. Specifically, it reduced the 39.6% rate to 37%, the 28% rate to 24%, the 25% rate to 22%, and the 15% rate to 12%.

What to Expect. At the end of 2025, income tax rates will revert to pre-TCJA levels. The result is that many taxpayers will be subject to increased income tax rates.

How to Prepare.

To prepare for 2026, taxpayers may want to:

- Accelerate income by converting, in whole or in part, a traditional retirement account to a Roth retirement account. The taxpayer will have to pay tax on the amount converted, but it may be better to do that now while rates are relatively low.

Assume, for example, the following facts: A single taxpayer has a \$3,500,000 traditional IRA. The taxpayer is in the highest income tax bracket, which currently corresponds to a 37% top marginal rate. The taxpayer anticipates being in the highest income tax bracket for the foreseeable future and also that the top marginal rate associated with that bracket will increase to 39.6%. The taxpayer must begin taking required minimum distributions (“RMDs”) three years from now, but the taxpayer will not need the distributions to maintain the taxpayer’s lifestyle.

Based on these facts, the taxpayer may want to convert their traditional IRA to a Roth IRA. The taxpayer will have to include the \$3,500,000 IRA in their taxable income for the year of the conversion, but this won’t push the taxpayer into a higher income tax bracket because the taxpayer is already in the highest bracket. After the conversion, the taxpayer’s IRA will grow income-tax free, and the taxpayer won’t have to take RMDs when the taxpayer is exposed to the anticipated higher rate.

- Accelerate income by taking more than the required minimum distribution (“RMD”) from a retirement account, then investing the excess in growth-oriented assets, with low anticipated portfolio turnover.
- Invest in a high cash-value life insurance product, if medical underwriting is favorable, or possibly in a private placement product, if the taxpayer is an accredited investor.
- If the taxpayer is age 70 ½ or older, reduce future taxable income by making qualified



charitable distributions from the taxpayer's IRA. This will reduce the value of assets on which future RMDs are based. To the extent the taxpayer cannot use the resulting charitable deduction in the current year, the taxpayer can carryforward the deduction for up to five years to offset future taxable income.

- For business owners who can somewhat control the tax sensitivity of their companies, defer losses and deductions until 2026 and accelerate income if possible.

3. **The AMT exemption and phaseout amounts will revert to pre-TCJA levels, indexed for inflation.**

Background. The purpose of the AMT is to ensure that higher-income taxpayers pay at least a minimum amount of tax. Taxpayers who are subject to the AMT are required to calculate their income tax liability under the standard rules and the AMT rules, and then to pay the higher tax.

A taxpayer calculates their income tax liability under the AMT rules by (1) calculating their taxable income under the standard rules, then (2) adding back certain preference items, i.e., income tax items that are lightly taxed or not taxed at all under the standard rules, then (3) subtracting therefrom the taxpayer's AMT exemption amount, if any, then (4) computing the AMT on what's left. Importantly, a taxpayer's AMT exemption amount begins to phase out at a rate of 25 cents for every dollar over a threshold income amount (the "phaseout amount").

The TCJA increased the AMT exemption and phaseout amounts, both of which are indexed for inflation. Compare, for example, these amounts in 2017, 2018, and today.

	Single	Married Filing Jointly	Head of Household	Married Filing Separately
2017				
Exemption Amount	54,300	84,500	54,300	42,250
Phaseout Amount	120,700	160,900	120,700	80,450
2018				
Exemption Amount	70,300	109,400	70,300	54,700
Phaseout Amount	500,00	1,000,000	500,000	500,000
2023				
Exemption Amount	81,300	126,500	81,300	63,250
Phaseout Amount	578,150	1,156,300	578,150	578,150

What to Expect.

At the end of 2025, the AMT exemption and phaseout amounts will revert to 2017 levels (in bold above), indexed for inflation. The result is that more taxpayers will now be subject to the AMT.



How to Prepare.

Two events, in particular, that can trigger the AMT are the realization of long-term capital gain and the exercise of incentive stock options ("ISOs"). To prepare for 2026, taxpayers may want to:

- Harvest long-term capital gains before the sunset. If a taxpayer holds assets with significant built-in gain and expects to sell those assets in the next few years, the taxpayer should consider selling the assets now, while the AMT exemption and phaseout amounts are relatively high.

- Exercise ISOs. An ISO is a right to purchase stock at a fixed strike price. Companies award ISOs to management-level employees to incentivize them by their work to cause the fair market value of the stock to exceed the strike price, so that if and when they exercise their ISOs the strike price is a bargain price. The problem is that, if a taxpayer exercises ISOs, the taxpayer is required to include the difference between the stock's fair market value and strike price in the taxpayer's AMT calculation. Thus, exercising ISOs can cause a taxpayer to pay AMT. If a taxpayer has ISOs that the taxpayer intends to exercise in the next few years, the taxpayer should consider exercising them now, at least to the extent the increased AMT exemption and phaseout amounts will protect the taxpayer from paying AMT.

4. Takeaways.

Absent Congressional intervention, individuals can expect to pay increased income tax beginning in 2026. To prepare, they may want to consider their options, such as: (1) accelerating income (2) using life insurance products and/or (3) deferring losses. Taxpayers should consult tax professionals for advice tailored to their specific circumstances.

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