EDUCATION

US Tax Reform: What Investors Need to Know

December 8, 2017

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On December 2, Senate Republicans managed to obtain enough votes to pass sweeping US tax reform legislation, but with several changes compared with the original House of Representatives' bill. At more than 470 pages, the "Tax Cuts and Jobs Act" is certainly not a light read. But, it has some important implications for individuals and corporations—for better or worse in some cases. Here, our Pierre Caramazza and Michael Doshier break down some key aspects of the tax reform bills that may impact many investors and highlight some substantial differences between the House and Senate versions.

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While Ben Franklin once said nothing is certain but death and taxes, aspects of the latter appear all but certain to change next year. With both branches of Congress passing tax-reform legislation, now it's up to a committee of negotiators from the House of Representatives and the Senate to reconcile the differences between their two bills. It seems there is a goal to get the final bill in front of President Trump in just a couple of weeks, before Congress breaks for the holidays.

The Senate and House versions of the "Tax Cuts and Jobs Act" do have differences that are still up for debate.

One of the main differences that may affect all US citizens is the tax brackets.

Currently, there are seven tax brackets for individuals: 10%, 15%, 25%, 28%, 33%, 35% and 39.6%. The Senate bill also has seven tax brackets, which cap out at 38.5%. For most income brackets, there would be a reduction. Meanwhile, the House bill has only four brackets: 12%, 25%, 35% and 39.6%.

On the corporate side, the House bill cuts the corporate tax rate to 20% (from 35% currently), starting in 2018. The Senate bill also drops the rate to 20%, but it would not take effect until 2019.

There are several other nuances that are beyond the scope of this article, and we encourage you to do your own research on the subject. As our area of focus is on investing, we would like to highlight a few aspects of tax reform that stand out to us. Not only in terms of how investments are taxed, but also in terms of changes to how individuals save and invest for college, retirement or some other goal.

Saving for College

For new parents, college represents a major expense that requires long-term planning. Both the House and Senate bills contain some changes related to 529 plans, which are vehicles used to save for college. Currently, money invested in these plans grows free of federal income tax when withdrawn for qualified higher education expenses such as tuition, books, and room and board (when attending at least half time). Depending on where you live, there may be state tax benefits, too.[1] We did not see any major changes in regard to the tax treatment of these plans in either bill. Given the skyrocketing cost of a college education, we find it encouraging to see saving for college remains a priority.

There were some proposed tweaks, however. Under the House and Senate bills, an individual may make a contribution to an “ABLE” account by transfer of the balance of a 529 plan. The Senate bill’s provision would expire at the end of 2025. An ABLE account is a tax-preferred savings account for persons with special needs. So, if you have an ABLE account and a 529 plan, you can roll the 529 plan balance into the ABLE account, as long as you don’t exceed ABLE account contribution limits.

Additionally, the House bill allows an unborn child to be a named beneficiary of a 529 Plan.

The Senate’s bill contains an amendment further broadening the scope and use of 529 savings plans. These plans would be able to be used for elementary and secondary schools (in addition to college), and would include private schools as well as home-schooling and tutoring.

We welcome changes that make it easier to save for educational purposes, including the broadening of the contributions to lower educational levels and for wider purposes.

Selling of Investment Shares

Both the House and Senate bills retain the current long-term capital gains tax rates, which also apply to qualified dividends. Currently, the rate is 0% for individuals in the two lowest tax brackets, 15% for the next four brackets, and 20% for taxpayers in the highest bracket.

While the mix of individual rate brackets is changing, we think it’s fortunate that capital gain rates don’t appear to be changing. Favorable capital gain rates were meant to encourage investment. We think keeping them low is important, and this year in particular, with US stocks hitting all-time highs, many investors would benefit from this special tax treatment when long-term holdings are sold.

One issue related to the timing of sales and how they are priced could affect certain investors, however. Under current law, an investor who accumulated shares of a security at different times and prices can choose which shares he or she wishes to sell at a given point in time. So, an investor can decide to sell shares of stock he or she bought at the highest price, or the lowest price—depending on the goal in mind. This can help minimize capital gains or offset other losses. Mutual funds can elect the same treatment for their investments, which helps smooth out reported capital gains distributions.

The Senate bill would require a “First-in-First-Out” (FIFO) treatment of these sales. That is, the oldest shares acquired must be sold first—more likely at the lowest prices for long-term holdings—thereby increasing the capital gains tax collected. Under the Senate bill, mutual fund shareholders would effectively have to choose between FIFO and the average cost method. However, the Senate bill includes an exception for investments sold or exchanged by a regulated investment company.

We would not be supportive of mandating FIFO. We believe an investor should be able to decide what he or she wants to sell and not be forced into one particular accounting convention. This has been a longstanding rule, but we can only assume the change is an attempt to generate revenue. If so, we don’t think accounting gimmickry which limits investor choice is a good way to do it.

One other interesting area we would note is a proposed 1.4% excise tax on net investment income of certain private colleges and universities in the House bill (and retained in the Senate version) that could have some ramifications for the broader investment industry and potentially the market. The theory is that these institutions are accumulating endowments beyond the needs of educating students and not paying out sufficient scholarships.

Retirement Plans

There was a bit of debate about the tax treatment of retirement savings plans, including defined contribution plans. Fortunately, the House and Senate bills leave the current system—which we think is generally working well to help Americans save for retirement—largely intact. Importantly, the current bill doesn’t call for “Rothification” of plans or changes to the contribution limits. We think this is a very positive development.

Current contribution limits were also left unchanged—including the “catch-up contributions” that individuals aged 50 or older can make. These catch-up contributions increase the amount older individuals can save on a tax-deferred basis in a 401(k) plan or individual retirement account.

We would note that the Senate bill would no longer allow contributions to a Roth plan to be re-characterized as contributions to a traditional IRA plan, which could have implications for some investors.

One thing we are monitoring from a retirement-plan perspective is potential unintended consequences of the pass-through proposals under consideration. The proposed changes could undermine the incentives for small business owners to sponsor a retirement plan for their workers. The impact on small businesses is a particular concern since those who work for small businesses are significantly less likely to have access to a retirement plan at work than those who work for larger employers.

What’s Next?

Of course, we don’t know which of these provisions will indeed make it into law. Now, Congress will debate the plans, and we assume some agreements will be reached on these and other key differences. We will be closely monitoring the process.

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US Tax Reform: Key Differences Between the House and Senate Bills

Provision	House Version	Senate Version
Tax Brackets (Single Filers)	12% > $0 25% > $45,000 35% > $200,000 39.6% > $500,000	10% > $0 12% > $9,525 22% > $38,700 24% > $70,000 32% > $160,000 35% > $200,000 385% > $500,000
Standard Deduction (Single Filers)	$12,200	$12,000
Corporate Tax Rate	20%, effective 2018	20%, effective 2019
Alternative Minimum Tax	Repeals, individual and corporate	Retains, but with higher exemption for individuals
Pass-Through Business Income	Lowers the tax rate on pass-through business income to 25%, or 9% for lower-earning firms	23% deduction to pass-through income
Mortgage Interest Deduction	Homeowners can deduct up to $500,000 in mortgage interest	Homeowners can deduct up to $1 million in mortgage interest
529 College Savings Plans	Expands use for lower education (K-12) Would include unborn children	Expands use for lower education (K-12) Adds amendment for private and homeschooling
Estate Tax	Exemption doubled, up to $11 million can pass tax-free, eliminates the estate tax by 2025	Same as House, but isn't eliminated
Individual Insurance Mandate insurance	Retains	Eliminates the tax for individuals without health

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1. It's important to remember that, as with any investment, principal value may be lost, and investing in the plan does not guarantee admission to college or sufficient funds for college. There is no federal or state guarantee of investments in the plan.