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PERSPECTIVES

US Tax Reform: This May Not Be the End

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admin

Congress successfully passed sweeping changes to US tax policy, which President Trump signed into law in December. Some of the earlier proposals contained changes that could have had a detrimental impact on the way many people save and invest for retirement, but fortunately, they were not included in the final bill. Pierre Caramazza and Michael Doshier are pleased our current retirement savings system was left largely intact, but caution that this tax legislation still has some open items. Whether addressed with a technical corrections bill next year or through IRS regulation, the refinement of the details will likely last well into next year, and the effects will be felt for years to come. They outline a few areas of interest to investors in the legislation as it stands today.

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The first major revision to the tax code in more than 30 years has now been signed into law. While the legislation will touch nearly every US citizen, the impacts on individuals and businesses will vary. Some will wind up owing less, or see certain tax benefits go away.

As our area of interest is investing—particularly saving for retirement—we are very pleased that current provisions aimed at helping Americans save and invest for retirement were left largely intact. The convenience of being able to contribute directly to an employer-sponsored retirement plan through payroll deduction makes it easy for millions of Americans to save for retirement—and that will still be possible.

It's important to note that most of the tax changes are set to take effect on January 1, 2018. The majority of the provisions targeting individuals in the new tax plan are set to expire at the end of 2025, while others (including a lowering of the corporate tax rate) are permanent.

Key Provisions at a Glance

While tax rates may indeed be lower for many taxpayers, those who have enjoyed benefits from itemized deductions and personal exemptions may face a higher tax bill going forward. And, residents of certain states with high state tax or inflated real estate taxes may also end up paying more. We would like to highlight a few of the key provisions on our radar.

- Income tax: Maintains seven individual brackets, with the top rate at 37% versus today's 39.6% rate. The new 37% top rate would apply to taxable income over $500,000 for single filers and $600,000 for joint filers. Meanwhile, the corporate tax rate drops to 21% from 35% today.
- Long-term capital gains/qualified dividends: Essentially remains the same, with a top 20% rate.
- The standard deduction: Jumps to $12,000 for single filers and $24,000 for joint filers, nearly twice current levels.
- Mortgage interest: Allows deduction for interest paid on new mortgages up to $750,000, down from $1 million currently. Also applies to second homes, but not to home equity lines of credit, which will no longer be deductible.
- State and local income taxes, real estate taxes and sales tax: limits Itemized deductions to $10,000 on any of the above that taxpayers choose.
- Child tax credit: Doubles from $1,000 to $2,000 per child.
- Alternative Minimum Tax (AMT): Retains AMT for individuals but won't apply to corporations. However, the exemption and phase-out amounts increase, so fewer individuals may be subject to AMT.
- Deductions: Repeals deductions for alimony, personal exemptions, miscellaneous itemized deductions such as unreimbursed employee expenses, tax preparation fees, safe deposit boxes and investment fees. However, the ability to deduct medical expenses will increase for taxpayers under 65, as the limitation for all taxpayers will now be 7.5% of AGI. The limits for cash charitable contributions will also increase from 50% of AGI to 60%.
- Pass-through taxes for small businesses: Permits S corporations, partnerships and sole proprietorships, including those owned by trusts, to deduct 20% of their qualified business income.
- Qualified tuition programs (529 plans): Allows tax-free withdrawals for up to $10,000 in tuition expenses at an elementary, or secondary school, in addition to higher education.
- Recharacterization of Roth Contributions: In the case of a qualified rollover contribution (including a conversion) individuals can no longer recharacterize a traditional individual retirement account (IRA) into a Roth IRA.[1] This limitation applies to qualified rollover contributions made from pre-tax accounts under an IRA, qualified retirement plan, 403(b) plan or 457(b) plan.
- 2016 Disaster Area Relief: Provides tax relief for certain retirement plan and IRA distributions taken from January 1, 2016 to January 1, 2018, by individuals whose primary residence was located in a presidentially declared disaster area at any time during 2016, and who sustained an economic loss by such disasters. Individuals eligible for a qualified 2016 disaster distribution are permitted to take a distribution from a retirement plan regardless of whether an in-service distribution is otherwise permissible.
- Excise Tax on University Endowments: Starting in 2018, imposes a 1.4% excise tax on the net investment income of certain private colleges and universities with certain provisions, including 500 or more full-time students and assets of at least $500,000 per student. The idea is to tax certain institutions that are accumulating endowments beyond the needs of educating students.

Muni Implications

There were some aspects of the new tax legislation affecting municipal bonds which will have implications for investors. The new tax law repeals the tax-exempt interest exclusion for advance refunding bonds, effective for advance refunding bonds issued after December 31, 2017. Advance refunding bonds represent a bond issuance used to pay off another bond, often issued at a lower interest rate. As this is a fairly common occurrence, repealing its tax-exemption is likely to affect those who invest in municipal bonds. That said, we are relieved that an earlier provision to repeal the tax-exempt interest exclusion for qualified private activity bonds did not become law.

This May Not be the Last Word on Tax Reform

The above is meant to be a high-level summary of some of the key aspects of the new tax policy, but certainly not an exhaustive or detailed list. We would advise individuals to consult their own financial advisor and/or tax professional for specific guidance on what it means for your unique situation.

As we have seen during prior tax reform efforts throughout US history, there are likely to be some impacts of this tax plan that legislators could not predict. And, there are likely to be some unintended consequences or even errors in the legislation that require correction. So, it would not surprise us to see a "technical corrections" bill next year or beyond to clarify and fix certain issues. We have no way of knowing what additional changes to our tax policy that may bring. Additionally, the Internal Revenue Service will be charged with enforcing this law—that is, writing regulations to roll it out. Some of the nuances of the new tax policy may be subject to interpretation.

We would again reiterate that if any future changes target the retirement system, those changes should be done with the exclusive goal of improving retirement readiness for all US citizens.

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1. A Roth IRA allows investment earnings to accumulate and be withdrawn tax free if the account has been established for at least five years, and you're at least 59½ years old. A Traditional IRA allows investment earnings to accumulate tax deferred, and depending on your income level and your participation in an employer-sponsored retirement plan, contributions may also be tax deductible. If taken prior to age 59½, a distribution will generally be subject to a 10% federal penalty unless it falls under certain exceptions.