How Will Tax Reform Impact Individual Investors?

We recently penned a letter outlining how the Tax Code changes may impact capital market expectations. Although the changes to corporate tax provisions were meaningful we concluded that the legislation is expected to modestly impact capital markets and that clients need not make material changes to their long-term asset allocation based purely on the passage of the bill. A copy of the report, titled How Will Tax Reform Impact Asset Classes? can be found on our website here. The following newsletter addresses the impacts to individual investors.

One of the most significant differences between institutional investors and individual investors relates to taxes. Therefore, the impact of the recent changes may be significantly more meaningful to individuals and their after-tax portfolio returns than an otherwise tax-exempt entity. And although we do not recommend managing investment portfolios purely based on tax laws, it is critical to understand how these changes may impact taxable investors and their ability to achieve after-tax goals and objectives. In the paragraphs ahead, we will address ordinary income brackets, capital gains, mortgage interest deductions, state and local tax (SALT) deductions, medical expenses, AMT, estate and gift taxes, charitable contributions, and 529 account funding. As always, we recommend that each investor speak with his or her accountant and/or estate planning attorney to understand how the tax law changes are applicable to each individual.

ORDINARY INCOME TABLES[^1]

The new law reduces the maximum marginal tax bracket to 37% from 39.6% while also reducing the tax rate for the other brackets as well. On the following page is a summary of the Married Filing Jointly and Single tax tables for higher income tax filers.
### MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES

If taxable income is: | Then tax is:
--- | ---
Over $77,400, but not over $165,000 | $8,907, plus 22% of the excess over $77,400
Over $165,000 but not over $315,000 | $28,179, plus 24% of the excess over $165,000
Over $315,000 but not over $400,000 | $64,179, plus 32% of the excess over $315,000
Over $400,000 but not over $600,000 | $91,379, plus 35% of the excess over $400,000
Over $600,000 | $161,379, plus 37% of the excess over $600,000

### UNMARRIED INDIVIDUALS OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS (i.e. Single)

If taxable income is: | Then tax is:
--- | ---
Over $38,700 but not over $82,500 | $4,453.50, plus 22% of the excess over $38,700
Over $82,500 but not over $157,500 | $14,089.50, plus 24% of the excess over $82,500
Over $157,500 but not over $200,000 | $32,089.50, plus 32% of the excess over $157,500
Over $200,000 but not over $500,000 | $45,689.50, plus 35% of the excess over $200,000
Over $500,000 | $150,689.50, plus 37% of the excess over $500,000

Regarding estates and trusts the brackets are as follows:

### ESTATES AND TRUSTS

If taxable income is: | Then tax is:
--- | ---
Not over $2,550 | 10% of taxable income
Over $2,550 but not over $9,150 | $255, plus 24% of the excess over $2,550
Over $9,150 but not over $12,500 | $1,839, plus 35% of the excess over $9,150
Over $12,500 | $3,011.50, plus 37% of the excess over $12,500

Given that investment yields around the globe remain low, a reduction in marginal income tax rates should produce less tax drag than before. The “pick-up” in income (i.e. tax savings) may be used to reinvest at prevailing market rates, increase savings, or for general distribution/gifting needs.

### CAPITAL GAINS TAX RATES

The new law segments capital gains tax rates by income level thresholds. It also increases the threshold for which the capital gains tax rates apply. The new thresholds are outlined on the following page.
Importantly, the new legislation modifies how the IRS adjusts tax brackets. Until recently, the IRS adjusted the tax brackets annually by using the Consumer Price Index (CPI), a widely followed gauge of U.S. headline inflation. The adjustments are made to mitigate tax bracket creep, i.e. the process by which individual tax payers are automatically moved into higher income tax brackets. The new inflation index will be the Chained Consumer Price Index (C-CPI-U). This is important because research has shown that Chained-CPI grows at a slower rate than CPI, thereby leading to faster tax bracket creep and somewhat higher tax payments over a longer time horizon.\(^2\) Congressional Budget Office (CBO) research estimated in 2013 that annual inflation as measured by Chained-CPI will be approximately 0.25% lower, on average, than annual inflation as measured by the traditional CPI.\(^3\) Lastly, in combination with the CPI adjustment, the cost-of-living adjustment base year was changed from 1992 to 2016. Research suggests that the underlying economic rationale for these changes is rooted in accounting for “substitution” effects. The Tax Policy Center states, “the difference between CPI-U and Chained-CPI is in how each accounts for immediate changes in the behavior of consumers when they face higher prices. The CPI-U assumes that increases in prices do not lead to substantial substitution effects.”\(^2\) Therefore, changing the base year allows for the adjustment of items in the basket of goods that may have been added or subtracted from the CPI calculations due to changes in consumer behavior.

**PASS-THROUGH ENTITIES**

Although we briefly highlighted this item in our previous report, we will review it again because many individuals may be “owners” of businesses classified as S-corps, partnerships, or sole proprietorships. Although the ordinary income brackets have been reduced, the headline rate of 37% exceeds the 21% rate for corporations. Therefore, to “level the
playing field” the new tax law allows owners a deduction of up to 20% for qualified business income, subject to several stipulations. The deduction is allowable for a vast number of service occupations, except for those in engineering or architecture. However, some highly paid professionals such as doctors and attorneys may not qualify for the deduction given the law’s unique details.

To qualify for the entire 20% deduction taxable income must be less than $157,500 for single filers or $315,000 for joint filers. For amounts more than these thresholds certain “phase-in” rules apply. The phase-in rules are triggered at income levels between $157,500 and $207,500 for single filers and $315,000 and $415,000 for joint filers. When the phase-in level is triggered the deduction is reduced and above the phase-in levels the deduction is eliminated. To conclude, the law stipulates that the total amount of the deduction cannot exceed taxable income; however, for losses the amount can be carried forward.

3.8% MEDICARE SURTAX

Unfortunately, the 3.8% Medicare surtax remains in place. This surtax was enacted as part of the Health Care and Education Reconciliation Act of 2010. It will continue to be levied on higher income earners.

MORTGAGE INTEREST DEDUCTION

The mortgage interest deduction is now limited to $750,000 in principal value, a reduction of $250,000 from $1,000,000. Notably, home equity lines of credit are no longer deductible.

STATE AND LOCAL (SALT) DEDUCTION AND ALTERNATIVE MINIMUM TAX (AMT) EXEMPTION

The new law regarding the SALT deduction has received many headlines. State and local taxes are capped at $10,000, including taxes on income, property, and real estate.

Research from the Tax Policy Center (TPC) indicates that “about one-third of tax filers opt to itemize deductions on their federal income tax returns, and virtually all who do itemize claim a deduction for state and local taxes paid.” The TPC research suggests that high-income households are far more likely to benefit from this deduction than middle-to-lower income households.

Further, it is critical to view SALT deductions in combination with AMT, a point that received fewer headlines on the news and in the press. The reason for this is because “although most high-income tax payers claim a SALT deduction, the federal individual alternative minimum tax (AMT) limits or eliminates the benefit for many of them. …Taxpayers cannot claim the SALT deduction when calculating their AMT liability, and the disallowance of the deduction is the major reason why taxpayers are required to pay the AMT.” As it pertains to the AMT Exemption, the threshold is as follows:

<table>
<thead>
<tr>
<th>AMT Exemption</th>
<th>New</th>
<th>Old</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$70,300</td>
<td>$54,300</td>
</tr>
<tr>
<td>Joint return or surviving spouse</td>
<td>$109,400</td>
<td>$84,500</td>
</tr>
</tbody>
</table>

Further, the amount of income taxpayers can have before the exemption is reduced is now $500,000 for those filing single and $1,000,000 for those filing jointly. This is a significant increase from $120,700 and $160,900, respectively. Lastly, the actual AMT rate remains unchanged at 28%.
ESTATE AND GIFT TAX EXEMPTIONS

The estate tax exemption was doubled to $11,200,000 for singles and $22,400,000 for couples. The marginal tax rate of 40% will remain in place for amounts exceeding these thresholds with a flat rate of 40% applied to generation-skipping-transfers.

INCREASED LIMITATION FOR CERTAIN CHARITABLE CONTRIBUTIONS

The total amount of cash contributions as a percentage of the taxpayer’s contribution base for such year is not to exceed 60%; the old limit was 50%. Furthermore, carry-over language was modified to include the updated 60% threshold.

529 ACCOUNT FUNDING

The treatment of elementary and secondary tuition now falls under “Qualified higher education expense.” 529 accounts can now be used for tuition relating to enrollment or attendance at an elementary or secondary public, private, or religious school. However, the cash distributions from all qualified tuition programs with respect to a beneficiary during any taxable year is limited to $10,000 in the aggregate.

CONCLUSION

In summary, the tax law changes will impact everyone differently and can be very difficult to decipher. Furthermore, taxes can have a significant impact on taxable investors and their investment portfolio returns. Therefore, it is important to consult with one’s accountant and/or estate planning attorney on how the full scope of the changes may specifically impact individuals.

Regarding investment management, we are keenly aware of the impact taxes can have on achieving goals and objectives. For individual investors, a risk-controlled portfolio management program is not complete without tax-awareness and we work diligently to accommodate both in our process at Marquette. As we stated in the introduction, we do not believe clients need to make material changes to their long-term asset allocation; however, with the changes there may be more flexibility to include certain asset classes within taxable portfolios that may have generally been excluded previously for tax efficiency reasons.

---

The sources of information used in this report are believed to be reliable. Marquette Associates, Inc. has not independently verified all of the information and its accuracy cannot be guaranteed. Opinions, estimates, projections and comments on financial market trends constitute our judgment and are subject to change without notice. References to specific securities are for illustrative purposes only and do not constitute recommendations. Past performance does not guarantee future results.

About Marquette Associates
Marquette Associates is an independent investment consulting firm that guides institutional investment programs with a focused client service approach and careful research. Marquette has served a single mission since 1986 – enable institutions to become more effective investment stewards. Marquette is a completely independent and 100% employee-owned consultancy founded with the sole purpose of advising institutions. For more information, please visit www.marquetteassociates.com.