

Tax Reform and Investing: Potpourri of Issues to Consider

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By now, you have probably read many commentaries on the tax ramifications resulting from the passing of the Tax Cuts and Jobs Act—500 pages and more than 72,000 words with 600 or so pages of explanation. Less is being written about tax reform and investing, but the majority of what we have read on this centers on whether the stock market will continue to receive a tax-cut boost, if tax reform has already been reflected in share prices, and what corporate chief financial officers will do with newfound cash. In this memo, we choose instead to focus on specific tax law changes through the lens of an investor to discuss issues in which tax law changes may be a reason to change or rethink an investment choice or course.

Individual Tax Rate Changes and Alternative Minimum Tax

With this legislation, the top federal tax rate falls from 39.6 percent to 37 percent. In addition, the deduction for state and local income, property, and sales taxes is now being limited to \$10,000.

The alternative minimum tax (AMT) survives but with a higher threshold. Because of the changes in the AMT structure, some investors who are accustomed to paying AMT will now pay regular tax. For these taxpayers, this means the top marginal federal tax rate on short-term capital gain (STCG) could jump from 28 percent to 37 percent—higher when state taxes are considered. Investors in hedge funds that are prodigious and perennial generators of STCG may wish to reconsider these holdings due to the after-tax wisdom of holding long-term versus short-term capital gain assets, especially when held in a taxable account.

Higher Gift Tax and Estate Tax Exemptions

For 2018, exemptions for both gift and estate taxes increase from \$5 million to \$11 million per individual (\$22 million per couple), before adjusting for inflation. This means that a couple can exempt up to \$22 million of assets from being subject to estate tax and still receive a full step-up in basis on these assets. Higher estate tax exemptions with full basis step-up at death mean more wealth can now pass through an estate, free from either income or estate taxes.

This, in theory, means taxable investment portfolios, which in whole or in part reduce or defer lifetime recognition of capital gains, will have more value when compared to higher turnover of taxable investment portfolios. This is especially true when the taxable estate is expected to fall under \$11 for individual or \$22 million for joint taxpayers, indexed for inflation, or when the taxable estate exceeds the exemption amount but is left to charity.

For families with wealth above \$22 million and expecting to pay estate tax, excessive turnover in a taxable portfolio will still hurt and should be managed. Note that paying income taxes on taxable portfolio turnover hurts less when estate taxes are present than when the end benefactor of an estate is a charity. This is because income taxes resulting from trading will reduce the estate tax on a taxable estate (e.g., \$1 of income tax reduces the estate tax by \$0.40), whereas income taxes reduce the after-tax bequest to a charity (e.g., \$1 of income tax reduces the amount to the charity by \$1).

36-Month Holding Period for Long-Term Capital Gains on General Partner Incentive

General partner performance incentive fees (i.e., carried interest) are now taxed as short-term capital gain unless gains are attributable to capital assets held for more than three years. The issue to watch here is whether general partners of hedge funds desiring favorable long-term capital gain (LTCCG) treatment on their carried interest change their investment process and trading behavior at their limited partners' expense.

The risk of this happening with private equity firms is small, as their normal holding period on investments exceeds three years. However, the same may not be true with other hedge funds whose normal investment time horizon is often far less than three years. Investors who purchased hedge funds to reduce portfolio volatility should pause if they see a change in trading patterns (from trading more often to trading less often) and consider whether the change is in their best pre-tax and after-tax interests, given the role hedge funds are intended to play in their portfolios.

Charitable Gifts

While not investment related, families with estate plans that include testamentary charitable bequests and whose taxable estates fall under the new higher estate tax exemptions may wish to make lifetime gifts instead. Of course, whether accelerating testamentary gifts makes sense depends upon a variety of client-specific factors. The new law does not change anything for families whose taxable estates are expected to be above the new higher estate tax exemptions. Gifts that reduce income taxes during one's lifetime are more tax efficient than testamentary gifts.

We expect charitable remainder trusts (CRTs) and charitable lead trusts (CLTs) to lose their appeal for taxpayers whose taxable estates are expected to fall under the higher estate tax exemptions and can afford to make direct lifetime gifts of appreciated property. CRTs may remain a means to diversify a concentrated low basis security (e.g., contribute low-basis stock to a CRT, retain a stream of payments from the trust, and pay tax on those payments over the life of the trust), but the arithmetic often shows CRTs are oversold, as other ways exist to diversify and accomplish charitable desires. CLTs retain their appeal for families whose taxable estates are expected to be above the new higher estate tax exemptions, especially considering today's low interest rates.

Interest Deductibility

The new law has rules that limit deductibility of business interest expense for corporations and partnerships. The rules are confusing, and, at this point, we have only two general observations to make. First, the lower corporate tax rate (21 percent) and the potential for the limitation on the deductibility of interest may make bonds less attractive to companies as they consider their capital structures. This change, coupled with the chance that repatriated cash from abroad will be used to reduce debt, could lead to a lower supply of higher quality corporate bonds and could cause a rise in bond prices. Second, given the prevalence of leverage throughout the hedge fund and private equity business, interest expense limitations that apply at the entity (fund) level merit careful attention as the year unfolds.

Dividends

Dividends will be taxed at 15 percent or 20 percent, which is the same rate as the long-term capital gains tax rate. Hence, when considered as a return of capital, dividends and share redemptions are at parity. What has changed is the spread between the top corporate tax rate of 21 percent and the individual tax rates (which for most clients are 32 percent to 37 percent).

Generalizations about dividends—their contribution to equity returns, their check against management misallocation of capital, or the emotional value of a dividend (vs. reinvestment of the same inside a business)—are dangerous. That being said, as an investor, excess free cash flow that remains inside a now lower-taxed C corporation (rather than being distributed to shareholders as a dividend) remains very attractive if it can be reinvested inside the corporation at an after-tax rate of return that exceeds the after-tax rate of return the shareholder could receive from investing the net cash from a dividend received after payment of income tax at the shareholder level.

Non-Resident State Municipal Interest

As mentioned above, high-tax-bracket investors will no longer be able to deduct most of their state income taxes on their federal return. This, in theory, will increase the after-tax value of resident municipal bond interest compared to nonresident state municipal interest.

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