COLONY FAMILY OFFICES

Brief Commentary on U.S. Tax Reform
December 20, 2017

After being passed by both the House and Senate earlier today, the most extensive changes to the tax code in over 30 years are on the way to President Donald Trump for his signature. The legislation reforms both individual income and corporate income taxes and will move the United States to a territorial system of business taxation. We are reaching out with some initial observations and will follow-up with additional detailed commentary.

Changes to Individual/Estate Taxes

- Lowers most individual income tax rates, including the top marginal rate from 39.6% to 37%. Retains the current seven-bracket structure, but bracket widths are modified.
- Limits the state and local tax deduction to a combined $10,000 for income, sales, and property taxes.
    - *This is a significant change from current law which allows for state taxes and local property taxes to be deducted completely. The bill also contains a provision that disallows the prepayment of state and local taxes in 2017 to avoid the new dollar limitation.*
- Limits the mortgage interest deduction to the first $750,000 in principal value (could be for a first or second home). Repeals the deduction for home equity loans.
- Leaves the current 401(k) and retirement plan rules largely unchanged.
- Limits the ability to deduct most other itemized deductions except charitable contributions, medical expenses above 7.5% of AGI (adjusted gross income) and student loan interest.
- Increases the AMT (alternative minimum tax) exemption amount from $86,200 to $109,400 for joint filers, and increases the phaseout threshold to $1 million.
- Doubles the estate tax exemption level from $5.5 million to $11 million.
- Effectively repeals the Affordable Care Act individual mandate by lowering the penalty amount to $0.
- The majority of individual income tax changes would be temporary, expiring on December 31, 2025.

Changes to Business Taxes

- Lowers the federal corporate tax rate from 35% to 21% starting in 2018.
    - *When combined with state corporate taxes, Strategas Research Partners estimates the combined tax rate will be 25.75%—this is still higher than the Organization for Economic Co-Operation and Development (OECD) average of 23%, but would be lower than all G-7 countries except for the United Kingdom.*
- Establishes a 20% deduction of "qualified business income" from certain pass-through businesses, such as partnerships, LLCs and S corporations. Specific service industries, such as health, law, and professional services, are excluded.
- Allows full and immediate expensing of short-lived capital investments for five years, meaning companies can write off 100% of their capital equipment purchases put in service by January 1, 2023.
- Places a mandatory tax on accumulated foreign earnings at a rate of 15.5% for cash profits and an 8% for reinvested earnings (plant and equipment). This is often called a repatriation tax.
    - *Under existing tax law, companies have been taxed at the full 35% statutory corporate rate for foreign profits brought to the U.S., beyond what was paid to foreign tax authorities. Foreign profits indefinitely reinvested outside the U.S. went untaxed—leading S&P 500 companies to accumulate some $2.5 trillion in unremitted foreign earnings. Repatriation is the first step in the process to transition to a territorial tax system which will allow companies to earn their active profits overseas and return their profits back to the US tax free.*
- Eliminates the corporate alternative minimum tax.

Potential Year-End Planning Activities

- Considering the above potential changes, we continue to actively evaluate and/or implement certain year-end planning activities on behalf of our clients.
- For example, in terms of income tax planning, we'll weigh the benefits of accelerating or deferring income and/or deductions based on a comparison of the 2017 and 2018 marginal tax rates (while taking into consideration AMT).
- We've also been re-evaluating the regular and AMT tax impact of purchasing state income tax credits in light of the new rules related to the cap on the deductibility of state income taxes.
- From an estate planning perspective, we'll reconsider large intra-family sales/gifts given the potential increase in the estate and gift tax exemption.
- We'll also proceed with the usual year-end activities, such as facilitating charitable contributions, annual exclusion gifts., annual IRA contributions and Required Minimum Distributions (RMDs). In addition, we'll review portfolios for opportunities to tax-loss harvest (subject to wash-sale rules) to offset capital gains.

Financial Market Backdrop and Potential Economic Impact

- Over the last few weeks, stocks seem to have been pricing in the increased likelihood of tax reform. Companies with the highest effective tax rates (or those that stand to potentially benefit the most from lower rates) have outperformed of late. Yet, we've seen little evidence thus far of financial markets pricing in higher levels of economic growth as the 10-year treasury yield is currently 2.46%, little changed from the start of the year.
- To be sure, a reduced tax expense is a benefit to corporate bottom lines and would likely increase corporate earnings in the short-term—potentially providing support for relatively high current equity valuations. Should the real economy begin to improve, however, higher interest rates could have an offsetting negative impact on earnings.
- The longer-term economic effect of the Tax Cuts and Jobs Act will largely be determined by the extent of new business investment and its impact on productivity and wages. The legislation seeks to reduce the cost of capital as an incentive to spur new savings and investment—both the full expensing of capital equipment purchases and move towards a territorial tax system are consistent with this effort. However, some are skeptical that new investment will result given that a prolonged period of low interest rates has not led to an investment boom.
- We'll continue to evaluate the potential impact and reach out with any changes to our assumptions and/or modifications to portfolio positioning.

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