GODFREY & KAHN S.C.

Investment Management **Focus**

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Congress Passes and the President Signs the Tax Cuts and Jobs Act

On December 22, 2017, President Donald Trump signed into law the tax reform bill commonly referred to as the Tax Cuts and Jobs Act (the Act). The Act contains the most sweeping changes to federal income tax laws in over 30 years, including cuts to the individual, corporate and estate tax rates. Although the Act significantly changes the tax rates applicable to investors, it does not make major changes to the federal income tax rules applicable to most common investment accounts or regulated investment companies.

Tax rates applicable to ordinary income in the hands of individuals have decreased overall

The Act immediately cuts rates for nearly all seven tax brackets applicable to ordinary income and short-term capital gains earned by individuals. The rates for 2018 will change as shown below:

Single individuals (other than surviving spouses and heads of households)

Old tax rates	Old tax brackets	New tax rates	New tax brackets
10%	$0 to $9,525	10%	$0 to $9,525
15%	$9,526 to $38,700	12%	$9,526 to $38,700
25%	$38,701 to $93,700	22%	$38,701 to $82,500
28%	$93,701 to $195,450	24%	$82,501 to $157,500
33%	$195,451 to $424,950	32%	$157,501 to $200,000
35%	$424,951 to $426,700	35%	$200,001 to $500,000
39.6%	$426,701+	37%	$500,001+

Married individuals, filing jointly, and surviving spouses

Old tax rates	Old tax brackets	New tax rates	New tax brackets
10%	$0 to $19,050	10%	$0 to $19,050
15%	$19,051 to $77,400	12%	$19,050 to $77,400
25%	$77,401 to $156,150	22%	$77,401 to $165,000
28%	$156,151 to $237,950	24%	$165,001 to $315,000
33%	$237,951 to $424,950	32%	$315,001 to $400,000
35%	$424,951 to $480,050	35%	$400,001 to $600,000
39.6%	$480,051 +	37%	$600,001+

Without further Congressional action, the reduced ordinary income tax rates applicable to individuals under the Act will expire on December 31, 2025.

The Act also changes how tax brackets are adjusted for inflation in the future. Prior to the enactment of the Act, the IRS used the consumer price index (CPI) to adjust tax brackets. The Act now requires tax brackets to be indexed to a slower inflation metric called "chained" CPI. In general, this will cause faster bracket creep than before. That is to say, taxpayers may be pushed into higher income tax brackets or have reduced value from credits and deductions due to the impact of inflation, as opposed to actual increases in their real income.

Tax rates applicable to capital gains and qualified dividends remain the same for individuals

The tax rates applicable to long-term capital gains and qualified dividends have not changed. The highest marginal income tax rate applicable to long-term capital gains and qualified dividend income remains at 20%.

Long-term capital gains rate	Single	Married, filing jointly
0%	$0 to $38,600	$0 to $77,200
15%	$38,601 to $425,800	$77,201 to $479,000
20%	$425,801	$479,001+

Note that these rates do not include the 3.8% net investment income (NII) tax, which remains in effect. The NII tax increases the top long-term capital gains and qualified dividend tax rate to a maximum of 23.8% for certain high income investors.

Alternative minimum tax has been changed but not eliminated

The alternative minimum tax (AMT) remains in place for individual taxpayers, but the Act increases both the AMT exemption amount and the AMT exemption amount phase-out thresholds for individuals. From 2018 through 2025, the AMT exemption amount has been increased to:

- $109,400 for married taxpayers filing jointly and surviving spouses,
- $70,300 for single taxpayers, and
- $54,700 for married taxpayers filing separately.

Over the same period, the taxable income level at which the exemption amount begins to phase out has been increased to:

- $1 million for married taxpayers filing jointly and surviving spouses, and
- $500,000 for single taxpayers and married taxpayers filing separately.

Note that for any calendar year after 2018, the Act indexes the amounts above for inflation. These revisions, in addition to the repeal of several items for regular income tax purposes (*e.g*., the repeal of (1) the deduction for state and local taxes in excess of $10,000, (2) the personal exemption deduction, and (3) the deduction for amounts previously accounted for as miscellaneous itemized deductions in excess of 2% of a taxpayer's adjusted gross income), should keep significant numbers of middle and upper income taxpayers out of the AMT.

Timing of income inclusion for certain accrual method taxpayers has changed

Under preexisting law, an accrual-method taxpayer generally includes items in income when the "all events" test is met. The test is met when all events have occurred that fix the right to receive the item and the amount of the item can be determined with reasonable accuracy. Under the Act, the "all events" test is treated as being met with respect to an item of income no later than when the item is taken into account as revenue on a "financial statement," as defined in the Act. The broadened "all events" test does not apply to a taxpayer that does not have a financial statement as defined in the Act for a taxable year. Illustratively, this rule may apply to income from original issue discount and market discount on loans and mortgage-backed securities. In the case of a mutual fund reporting items differently for GAAP purposes and federal income tax purposes (such as, if the mutual fund generally reports on a mark-to-market basis for GAAP purposes, but on an accrual basis for income tax purposes), the mutual fund could be forced to include items in taxable gross income because they were taken into account as revenue on a financial statement. This could produce distorted results, affecting the timing, amount, and tax treatment of mutual fund distributions to shareholders, because the broadened "all events" test provides rules only for income, not loss, inclusion.

Tax-deferred retirement accounts, including IRAs and 401(k)s, have generally not changed

The federal income tax rules applicable to individual retirement accounts (IRAs) and 401(k)s have generally stayed the same and traditional versions of those accounts retain their tax-deferral benefits. Early drafts of the Act suggested that the tax deduction for contributions to traditional IRAs or 401(k)s might be severely curtailed or eliminated, but those provisions were not included in the enacted version of the Act. The Act did eliminate the ability to reverse or recharacterize a traditional IRA to Roth IRA conversion after it has occurred.

Tax-lot selling rules have not changed and FIFO has not been mandated

Investors retain the right to determine their preferred tax lot to use for cost basis purposes when selling investments. The Act retains a helpful tax planning tool for investors. In an early Senate draft of the Act, a provision would have required investors to use first-in first-out (FIFO) accounting, which would have forced investors to use the cost basis of the securities that they bought earliest when selling securities from any particular issuer. This would have accelerated capital gains for many investors.

Tax-exempt status of interest on municipal bonds and private activity bonds is preserved

Early drafts of the Act proposed eliminating the rules that exempt from gross income the interest on private activity bonds, typically used to fund hospitals, affordable housing, universities, and charter schools. The Act retains the tax-exemption applicable to both municipal bonds and private activity bonds, but not advance refunding bonds.

Source: An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97 (2017).