Transcript

Better conversations. Better outcomes.

Episode 45 – Deciphering tax reform: Takeaways for advisors

Mike Barry - Not doing Rothification, which is a big deal. And then on top of that, getting a reduction in the corporate tax rate and no change in the treatment of tax-exempt entities, including retirement plans is also a big deal. And people didn't pay much attention to it, but that's a big deal. Both of those are a big deals. I mean one is negative, that something bad didn't happen, but they both benefit our industry significantly.

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Emily Larsen - And I'm Emily Larsen. In each episode, we'll explore topics relevant to today's trusted financial advisors, interviewing experts and investigating the world of wealth advising from every angle. We'll also provide you with actionable ideas designed to improve outcomes for advisors and their clients.

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Emily Larsen - Before we get started, one quick request. If you have enjoyed the show and found them a value, please take a moment to leave us a rating or review on iTunes. It would really mean a lot to us.

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President Trump - Hasn't been done in 34 years, but actually really hasn't been done because we broke every record. It's the largest -- I always say the most massive, but it's the largest tax cut in the history of our country, and reform, but tax cut. Really something special.

Emily Larsen - Happy New Year and welcome to the first episode of 2018. You probably guessed it from the clip of President Trump; today we're talking tax reform. The final bill represents a large change to the US tax code, and the Bill was signed into law by President Trump on December 22nd of 2017.

Ben Jones - Today we're going to examine the new tax code from two different perspectives with two different experts. First, you heard Mike Barry at the top of the show. He'll lead the conversation about how this bill will impact retirement policy, plans, and savers. Mike is the president of Plan Advisory Services and has more than 40 years of experience in the field of retirement policy.

Emily Larsen - Later, we'll speak with Marc Van Bell on how tax reform impacts the municipal bond market and tax-exempt investors. Marc is a product specialist of municipal fixed income at BMO.

Ben Jones - You may be familiar with the way the CBO scores proposals such as this tax reform bill in what they call their 10-year budget window. Every part of the bill, whether it's about retirement policy, municipal finance, or other things, has to be accounted for as part of that 10-year budget window. So when developing a bill like this, it becomes a negotiation of trying to find ways to offset or reduce the expenditures in that 10-year window. Mike explains this at a high level.

Mike Barry - I'm going to do this focusing on the problem that retirement savings presents for that 10-year window process.

Ben Jones - Perfect.

Mike Barry - My understanding of this process -- and I've never been part of the CBO, so it's kind of a black box the way that they do this, so I can give you the broad outlines but there may be people out there that can describe this with more accuracy and more detail. But my understanding is that the way they take a look at -- let's take a 401k contributions, that's the most intuitive sort of retirement savings to talk about. So the way they look at is they look at 10 years, and they look at what happens in 10 years in the 401k system. They look at how many people make regular 401k contributions and therefore don't pay taxes on the contributions that are going into the plan. They look at the earnings during that period that also aren't taxed. Those are both in effect debits to revenues. You're losing revenues because people are putting -- during the next 10 years people are going to put money in the plan, and then they're going to earn on their investments, and they're not going to pay taxes on either of those. That's a revenue expense, that's a tax expenditure. You then credit for the same period all of the people during that 10-year period that are taking distributions from their 401k plan and paying taxes on them. If anybody's got any kind of accounting background, it's basically cash accounting. They're just doing a cash accounting approach to the cost of a 401k plan. So much money is lost in deductions and the non-taxation of investment earnings; so much money is gained in taxing distributions. The net of that produces this number for -- there's a big number that wraps up all retirement savings.

Ben Jones - That big number that Mike's talking about. Well, according to the Tax Policy Center for fiscal year 2018, the retirement expenditure for DB and DC plans is over $140B, easily making it one of the largest expenditures in the budget. And so one of the problems that this poses, the way I understand it, is that a lot of these contributions that people put in will generate tax revenue down the road, but it'll be outside of this 10-year window.

Mike Barry - Yeah, people have argued that the right way to do this would be -- and I read a really interesting paper by a couple of guys at Treasury that went through this analysis is that the right way to evaluate the cost of someone saving for retirement is to take the present value today of this year's contribution, or the present cost to revenue today of this year's contribution. So you would take the value of the deduction, offset by the ultimate value of the taxes paid, and then the present value of the investment earnings that are not taxed. And when you do that, if your tax rate is the same at the time of contribution and the time of distribution, then that value will be the present value of the non-taxation of investment earnings.

Emily Larsen - First, we'll look at what the reform bill did not do to retirement plans. For the most part, it did not end up changing 401ks. Initially it had been proposed that the 401k might be Rothified and that it would bring about significant changes to the system.

Mike Barry - This possibility that they were going to Rothify the 401k contributions in order to raise revenues within the budget window to pay for the corporate tax cut. That would have been problematic in a number of respects. To me as I've thought about this, and I tried to think about it, and it was really interesting. One of my takeaways here is that it turns out that 401k plans have a lot more political traction, a lot more leverage than I think maybe a lot of us thought. It only took a Tweet from President Trump and some Democrats coming out and denouncing this proposal to basically kill it. I mean, it got floated. We knew they were talking for it for about a year, and there were some specific proposals floated. It was in Dave Kant's version of tax reform a couple of -- five or seven years ago. And yet as soon as it got exposed to daylight, it died. I guess we should spend a little bit of time just being clear about what Rothification is. But I want to come back to how important it is that we get to keep regular 401k contributions. Regular 401k contributions go in tax-free, they accumulate earnings tax-free, and then they're taxed on the way out. Roth contributions are taxed up-front, accumulate earnings tax-free, and then are not taxed on the way out. If your tax rate is the same at the beginning and at the end, that is at the date of contribution and at the date of distribution, then the tax then, the 401k tax benefit is the same, whether it's Roth or regular contributions. The beauty that the Congressional Republicans saw in Rothification is that if you tax this money on the way in, that's going to put a lot more tax revenues within the 10-year budget window, and then they can use those revenues to help pay for the corporate tax cut. The problem is that Roth contributions allow someone starting out in their career who's not getting paid a lot of money to make a contribution, pay taxes now at that low tax rate, and then when they -- if they're successful, when they take the distribution and they're in a higher tax bracket, it's not going to be taxed. I call that just sort of intuitively income shifting. That participant in a Roth situation is shifting income from a low tax year to a high tax year. But in a low tax year he pays taxes, and then in the high tax year he doesn't have to pay the taxes. That's the beauty of Roth contributions, very appealing to younger employees it seems to me. For the regular 401k contributions, you can do income shifting the exact opposite way. If you're in mid-career and you’re at peak earning, you're in the highest tax bracket you're ever going to be in in your life, you can put money in a 401k plan, get it out of that high tax bracket, leave it in the plan until you retire. And if you're in a lower tax bracket when you retire, you take the money out and pay taxes then. That's a big tax benefit. I think what we saw with this overwhelming response against the idea of Rothification is that a lot of people, and not just rich people, a lot of middle class people value that feature of 401k plans. They may not understand the theory that I just went through, but I think they get it that I'm getting a deduction now, and I kind of feel like when I take this money out, I'm probably not going to be paying taxes at this higher rate that I'm paying them at now. So I'm going to put money on a regular 401k basis now. Dodging that bullet -- and that's probably not the right metaphor -- the broad opposition to that I actually think kind of changes the way the politics of our retirement savings is going to work going forward. Five years ago or less Democrats were complaining about the 401k system and that all the benefits went to the rich. During this debate over Rothification, Chuck Schumer described the Rothification proposal as a tax hike on middle class retirement accounts. I think this change that's happened, that Democrats now see themselves as defenders of the current 401k tax system is really interesting politically. I think it's going to be a big help to us. We may actually be able to get some things done as long as they stick to that talking point, that 401k plans are good for the middle class.

Chuck Schumer - No matter which way you slice it, what the Republicans plan to do to 401ks is an immediate tax hike on American families' retirement plans period.

Ben Jones - That statement from Chuck Schumer, as well as pressure from other Democrats, is partly what prompted President Trump to Tweet this out on October 23rd: "*there will be no change to your 401k. This has always been a great and popular middle class tax break that works, and it stays.*" As Mike states, this agreement to leave the 401k alone shows just how popular the 401k has become over the years.

Emily Larsen - Now that we know what's not included on the bill, let's dive into a few specific changes that will impact retirement accounts.

Ben Jones - What's kind of your first take-away from this new bill for retirement policy.

Mike Barry - Well, the largest one is what happened with the corporate tax, but that's a little indirect. Let's note too that I don't consider as significant as the decrease in the corporate tax, but are much more explicit impact on retirement plans, and those are first a very small ball one is that they extended to the tax return due date the period in which a participant could roll over the unpaid balance of the loan when the participant terminates employment. That's going to be helpful for that specific situation, which is kind of a problem for a lot of people. You've got a loan outstanding, there's a payroll withholding on it. When you terminate employment, the payroll withholding goes away and they just distribute the unpaid balance of the loan to you as a distribution. You've somehow got to get the money, if you want to roll it over you've got to get the money together to then put that money into an IRA, for instance. And you under old law had 60 days to do that, and under new law you have until your tax return due date for the year in which you received the distribution with extensions. So for most people, that will be October 15th. So that's a good thing, very small potatoes, but still nice to get. The other thing that we need to note, which is a little indirect but still everybody's been -- maybe not everybody, but people in our world have been very concerned about its impact on the plan formation and the continuance and maintenance of retirement plans, is the deduction for individual business income. This was a big headline element of tax reform, that there's going to be a 20% deduction from individual business income. That's going to reduce owners who have this individual business income, a small business like a 7-11, that's going to reduce their tax rate.

Ben Jones - This is also often referred to as the pass-through portion of the bill, correct.

Mike Barry - This is pass-through, yes. The problem that we've all been concerned about is that for business owners that have income that's eligible for this treatment, it may not be in their interest to save in a tax qualified retirement plan. If it's not in their own personal interest to save, then they may not set up a plan for their other employees. It may not be in their own personal interest to save because they've got this reduced tax rate if they pay income tax now and don't save it in a qualified plan. But if they put it in a qualified plan and save it for whatever, five, ten years, and then take a distribution, that distribution will be taxed at ordinary income tax rates, at the full 37% rate. They won't get the benefit of that 20% deduction. I mean there are situations where it's still -- in fact, it maybe the majority of the situations where it's still better to save in a plan. But there will also be situations in which you lose money saving in a plan. This may discourage plan formation in that world. I think one of the questions for 2018 and beyond is going to be understanding exactly how that pass-through rule works and how it's going to affect the formation of retirement planning. So those are the two really obvious things, it seems to me, that affect our world that are in this bill.

Ben Jones - That pass-through thing is highly circumstantial, right. Because there will be people that, as you point out, will be better off saving in a retirement plan or a qualified plan, and there will be some that are much better off outside of the qualified plan. I also would note that for all of the advisors that are out there that were hoping they could use this pass-through charge, while we don't give out tax advice on the program, consulting was specifically called out as not eligible for the pass-through.

Mike Barry - They generally excluded professional services income from the pass-through treatments. They provided a list of what they consider professional services. Lawyers are also on that list, accountants are on that list, investment bankers. It depends, right. I think if you get a W-2, it's not going to be a business. That change, while it looks like a problem, and I say that straight up, I think it's going to be a problem, I don't think it's going to be a huge problem. I think we've got to get a feel for it. The exclusion of professional services income from the pass-through benefit is going to take a lot of people that are very tax motivated out of this mix. I think a lot of the people that remain that are just running ordinary businesses that have to go hire people, a lot of those guys don't have plans to start with. Those that do may not just be tax motivated or it may not be their own tax motivation that they're concerned about. They may have employees that want a 401k plan.

Ben Jones - Wonderful. So that's something to watch in the year ahead. So let's talk about this other point that you mentioned that you want to circle back to here, which is the reduction in corporate rates, and the potential for those to translate into better returns for participants of qualified plans.

Mike Barry - Yep, let me say this as simply as possible: the increases in stock prices and returns that we've seen and that some at least expect that we're going to continue to see go into the participants' account in a 401k plan and aren't taxed. That's an improvement in the 401k tax benefit. It's an improvement because that's not a one-time event, that's an event that's a result of the long-term reduction in the corporate tax rate.

Emily Larsen - So to recap Mike's thoughts on the tax bill's impact on retirement policy: first, it extends the period for the rollover of unpaid loans. Secondly, the reduction in corporate tax translates into potentially higher investment return and that in a 401(k) plan those higher returns are not taxed, and that translates into a higher 401(k) tax benefit. Thirdly, for pass-through entities, it actually may discourage some smaller plan formation, and this is something to watch in the year ahead. But the bottom line is while there were some initial concerns about major retirement policy impact, the final bill has no significant changes for retirement savings policy.

Ben Jones - Now let's turn our attention to the municipal bond market, and our second expert, Marc Van Bell. We'll take a look at how tax reform will impact tax-free investors.

Marc Van Bell - Really why the municipal market is top of mind here with legislators is, I mean, it is a tax-exempt market. So investors that are investing in our world generally are not paying federal income tax, in most of the case. There are such a thing as taxable municipal bonds as well, but the vast majority are tax-exempt, meaning free of federal income tax on the interest you're going to earn. In many states as well they are also tax-exempt, so they have not only freedom from federal tax levy but also state taxes. Especially important in higher tax states, say like a California or a New York, where that can be very beneficial to investors. Why did the municipal space get impacted, or at least have legislators set their sights on it, is they needed to find ways to offset the tax reform as far as what we're going to spend as a result of decreasing some taxes, that needed to be offset. So in round numbers, we're talking about a trillion and a half of savings that we needed to find, or offsets is a better word really, for lowering things like the corporate tax rate, which now law of the land as of January the 1st, 2018, corporate taxes will go from a 35% statutory rate down to 21%. So some of the provisions within municipal investing were initially targeted by legislators to remove from the tax code. One of those is advance refunding bonds which actually will be eliminated as the calendar turns. And the other area which was initially targeted by the House of Representatives and ultimately didn't make it into the final legislation was the elimination of private activity bonds. Those bonds largely used by entities like not-for-profit healthcare, airport authorities to help fund their infrastructure projects, those remain tax-exempt and those issuers will have access to the tax-exempt fixed income markets in the new year. So again, it's just legislators looking at a place where there's tax-advantaged income, investors might benefit in trying to find ways to largely pay for that corporate tax.

Emily Larsen - If you watch the muni market, you'll know that there was a bit of turmoil during November and December due to the uncertainty around what was going to be in the final tax reform bill. Bottom line, so the final bill didn't turn out to be as bad for the muni markets as some feared, but there were some changes. Here's Marc.

Ben Jones - Let's talk about the elimination of tax-exempt advanced refundings.

Marc Van Bell - So advanced refundings, which is really a way of saying issuers are able to refinance outstanding in advance of the actual final maturity. This is something that is generally advantageous to issuers as interest rates are falling. You can take currently higher price debt, refund that at new lower rates now. So that obviously has been on the decline already, given the rising short-term rates we've seen here since late 2016. But nevertheless, still about 15% or so of the overall new issuance market in municipal space. So that is going to be going away. Again, we saw a lot of rush to market here at the close of the year trying to get in under the changes in the tax law. But that's one thing that municipalities will not be able to take advantage going forward. That should shrink overall supply of new debt somewhat.

Ben Jones - I want to just kind of break this down so that I understand it, and then I have a quick question related to this. This is kind of like if people own a house, and interest rates fall, and they refinance their mortgage to take advantage of lower rates. So cities, and states, and municipalities do this as well, and this is called kind of an advanced refunding effectively. It's basically refinancing their outstanding debt to take advantage of lower rates. Is that accurate?

Marc Van Bell - Correct, that's exactly right.

Ben Jones - One comment that you had that caught my attention was that it's about 15% of new issuance historically, and so this would lower the overall supply. But just help me out here, if you refinanced outstanding debt, wouldn't the overall supply remain the same, because you're taking debt off the market and adding new debt on to the market, or am I thinking about this wrong.

Marc Van Bell - Yeah, the new -- so it's about 15% right now, and that's the -- down from over 20%. I think it got as high as 25% perhaps in recent years. But with rates now starting to move back up, that share, I guess -- I should think about it as 15% of the overall supply. So it's a smaller piece of the overall new issuance I guess maybe is a better way to say it. But it's going to be about 15%. But again, that's not going to be a tactic that municipalities are going to be able to undertake now. So you'll see that market continuing to wane, and I guess theoretically those outstanding bonds probably trade a little bit off as new issuance comes out at higher rates.

Ben Jones - So I want to understand why do you think this got included in the bill. Because it doesn't strike me like, given that interest rates are rising, this is probably going to be declining anyway. Why do you think this got included into the bill, and what kind of benefit does this have for helping them reach this offset number?

Marc Van Bell - Yeah, it's a fairly small number as far as the offset goes, I mean less than probably $30B over the 10 year period that a lot of these provisions in the new tax law are going to hold. But I guess many of the legislators felt this is a loophole, they wanted to try to close that loophole. Although something about making the tax code simple through this whole process I think got thrown out the window. So things are maybe slightly less complex overall, but there's probably just as many loopholes as we had prior to the new legislation. It's just something that stands out, some, again, legislators felt this is a loophole that shouldn't be exploited by municipalities.

Ben Jones - Let's move on to the second thing that I think was a bit of a surprise to many people who were watching kind of the tax debates over the course of the last 12 months. That is that individual tax rates really didn't change that substantially. You mentioned earlier that the rates went from 39 to 37 at the top end of the bracket, and that some of the AMT thresholds increased. But this was something that didn't really change, and I think the muni market at one point was really concerned that if rates went down too much, it might hurt demand. So talk me through this a little bit.

Marc Van Bell - Right, two points to make there, Ben. The first one I guess as far as overall muni demand goes, like you described, individual tax rates are not changing drastically. They're still going to be top 37% marginal rate. Where we are seeing the real difference is on the corporate tax side, so that's declining 35 to 21 on a statutory basis. Many investors may not know this, but approximately 23%, 24% of the overall investor base within municipal bonds is actually corporate entities such as banks that use munis as part of a diversification effort within their fixed income portfolios. So, there was some concern perhaps that that corporate bond buyer could go away due to that 21% corporate tax rate. Now, while that's certainly true, there is also going to be less ongoing supply with things like advanced refundings going away. Overall, with the other I guess key piece of this is the state and local tax deduction was originally targeted by both houses, or both branches of Congress, to be eliminated. Now in the final bill it was capped. So individuals are going to be able to deduct up to $10,000 in state and local taxes. The argument would be that folks in high tax states such as New York, California, a lot of the coastal markets along with some of those in the Midwest like Illinois, there's still going to be additional incentive by those bond buyers to seek out municipal fixed income investments, especially in those states, because they're going probably to be most impacted by that cap on state and local taxes. They're in other words going to be paying more tax, therefore will have the incentive to seek tax-exempt income to the extent possible.

Ben Jones - Alternatively, beyond the SALT maximum of $10,000, the mortgage interest deduction also went down from 1M to 750,000. If you think of those coastal areas, that's some of the most expensive real estate in the country. I have to imagine that there will be a lot of folks from these higher tax areas that are looking for ways to achieve income at a tax-advantaged rate.

Marc Van Bell - That's exactly right. That was another provision that was one of those things that went through some horse trading in the conference committee. As you mentioned, the Senate wanted to keep that at $1M mortgage interest deduction limit, the House originally had 550,000 in their version of the bill. So they kind of met almost in the middle at 750. That's --

existing outstanding loans are going to be grandfathered, but anything new you're going to have to have under a $750,000 mortgage to deduct that mortgage interest from your federal return. Again, another probably some knock down effect on house prices in some of those markets. I've seen anywhere from 1% to 3% estimated. Time will really tell if people are going to be willing to trade down in houses. I would argue in some locales you probably won't be able to even if you wanted to. But it should be overall supportive of investors trying to seek out ways to minimize their overall tax bill. Certainly investing in tax-exempt fixed income can be one way to help mitigate your tax bill.

Ben Jones - So the tax bill did not have the market changing provisions that some muni investors originally feared. But there are some changes, and those might lead to some supply decrease over time. Overall, Marc points out that for tax sensitive investors, munis still have a compelling investment structure.

Emily Larsen - Mike and Marc both had great final words of advice when considering this new tax code.

Mike Barry - We can read the statute, but lots of people have pointed out there's a lot of stuff in the statute that's not as clear as you would like it to be. We're going to have to work with this some before we can figure out how it works. I wouldn't take it right to the bank that you can do X, Y, or Z. But I mean, this is always true of tax legislation is that it gets written sort of on the fly. These people are pretty competent at writing things, but they don't have the benefit of this crowd of accountants, and financial planners, and other advisors that are trying to figure out ways to reduce individuals and corporations' tax burden. That group of brains is going to figure out things to do with this new tax regime that the people who wrote it weren't thinking of.

Marc Van Bell - Well, we're always going to be subject to what happens with politicians. So keeping an eye on not only what's transpired in Washington, D.C., but how that affects state and local governments as well, that's something we'll have to keep an eye on here as we move into the mid-term election cycle. Some of this could be somewhat limited in scope if you get a change in Congress in the 2018 elections. That's something we'll watch if the new law comes under pressure here, things that could change from where they sit today.

Emily Larsen - We have a paper detailing Mike's thoughts that includes the new tax tables available at bmogam.com/betterconversations, as well as links to his website and how to subscribe to his mailing lists on retirement policy issues. We also have the link to our monthly muni insights where you can follow Marc's team if you'd like to learn more about their thoughts around the municipal markets.

Ben Jones - Thanks for joining us on what's going to be another exciting year of the show. I especially want to take a moment and thank both Mike and Marc for making time to speak with us during their holiday breaks. We really appreciate it guys, thank you. Thanks for listening to *Better conversations, Better outcomes*. This podcast is presented by BMO Global Asset Management. To learn more about what BMO can do for you, visit us at www.bmogam.com/betterconversations.

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Ben Jones - And I'm Ben Jones. From all of us at BMO Global Asset Management, hoping you have a productive and wonderful week.

Emily Larsen - This show and resources are supported by a talented team of dedicated professionals at BMO, including Pat Bordak, Gayle Gibson, Matt Perry, and Derek Devereaux. This show is edited and produced by Jonah Geil-Neufeld and Annie Fassler of Puddle Creative.

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