

AMT and State Tax in New Tax Law: How Will Changes Affect Your Clients?

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Highlights of Changes for 2018: Investors

- State income tax no longer deductible*
- Top-bracket rate drops for short-term gains
 - Some clients paying more taxes
 - Some clients paying less
- Pease phase-out repealed
- Medicare tax of 3.8% remains in force (net investment income tax, NIIT)
- Alternative minimum tax (AMT)
 - Some changes to exemptions/phase-outs
 - Big impact on whether AMT is triggered

*Throughout this presentation it's assumed that ultra-high-net-worth taxpayers will have already exceeded the \$10,000 limitation on deduction of state and local tax payments, making state income tax effectively not deductible on the margin.

Highlights of Changes for 2018: Universities

What Would Yale Do If It Were Taxable?

Financial Analysts Journal
July/August 2015



The subjunctive now becomes the indicative.

(In plain English: the hypothetical is now the actual.)

Changes Not As Directly Affecting Investing

- Property tax no longer deductible
- Some pass-through entities qualify for a deduction
- No more miscellaneous deductions
- Increase in estate tax threshold
- Big drop in corporate rate
- Higher standard deduction but no exemptions
- Mortgage interest capped at loan of \$750k

What Remains Unchanged?

- Charitable donations still deductible
- Cash donations now up to 60% of adjusted gross income (AGI)
- Long-term capital gain treatment and federal statutory rates
- 3.8% Medicare tax on NII (net investment income)

Rate Changes (Top Bracket), Federal Only

	Old	New	Difference
Regular Federal Tax Rate			
Ordinary income or short gains	39.6%	37.0%	-2.6 pp
Long gains	20.0%	20.0%	0.0 pp
State taxes deductible?	Yes	No	Big!
Federal AMT Rate			
Ordinary income or short gains	28.0%	28.0%	0.0 pp
Long gains	20.0%	20.0%	0.0 pp
State taxes deductible?	No	No	None!

Note: Changes ignore effects of Pease phase-out. Taxpayers formerly subject to Pease limitation may see additional drop of 1.2 percentage points on both short- and long-term gains due to repeal of Pease in 2018. Aperio shows most research without Pease.

Effective Rates, Fed & State Combined

State Tax		Old	New	Difference
13.3%	CA Short-Term	50.9%	54.1%	+3.2 pp
13.3%	CA Long-Term	31.3%	37.1%	+5.8 pp
6.0%	MO Short-Term	46.8%	46.8%	0.0 pp
6.0%	MO Long-Term	27.2%	29.8%	+2.6 pp
0.0%	TX Short-Term	43.4%	40.8%	-2.6 pp
0.0%	TX Long-Term	23.8%	23.8%	0.0 pp

Note: Changes ignore effects of Pease phase-out. Taxpayers formerly subject to Pease limitation may see additional drop of 1.2 percentage points on both short- and long-term gains due to repeal of Pease in 2018. Aperio shows most research without Pease.

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13.3%	CA Short-Term	50.9%	54.1%	+3.2 pp
13.3%	CA Long-Term	31.3%	37.1%	+5.8 pp
6.0%	MO Short-Term	46.8%	46.8%	0.0 pp
6.0%	MO Long-Term	27.2%	29.8%	+2.6 pp
0.0%	TX Short-Term	43.4%	40.8%	-2.6 pp
0.0%	TX Long-Term	23.8%	23.8%	0.0 pp

Discussion Points:

1. Why does California L/T rate increase more than S/T?
2. Why is there no change for Missouri S/T?
3. Why is there no change for Texas L/T?

Effective Tax Rates

2018 Aperio Tax Guide for Investment Decisions aperio

EFFECTIVE FEDERAL INCOME TAX RATES

Fed Only + Medicare 3.8%

	2017	2018
Regular		
Short-Term Gains & Ordinary Income	43.4%	40.8%
Long-Term Gains & Dividends	23.8%	23.8%
Alternative Minimum Tax (AMT)		
Short-Term Gains & Ordinary Income	31.8%	31.8%
Long-Term Gains & Dividends	23.8%	23.8%

NOTES & METHODOLOGY

The calculation of the rates shown above reflects the following assumptions:

All rates reflect the highest marginal tax bracket for each jurisdiction. Dividend rates apply only to qualified dividends. Rates include changes from the Tax Cuts and Jobs Act of December 2017. For federal tax only, the rates shown are based on the highest marginal tax rate of 37.0% plus the 3.8% Medicare rate, also known as tax on net investment income. For rates that include state taxes, those are added to the federal rate. No deduction is included against federal liability for the payment of state taxes. It is assumed that these rates apply to top-bracket taxpayers who have already surpassed the \$10,000 limit on state and local tax deductions against federal income.

The table below shows the calculation for both regular and alternative minimum tax rates for federal, plus an example of a state with a rate of 13.3% only to illustrate the math. Residents of other states may pay lower rates. Taxpayers with lower taxable income than presumed or other tax situations may experience different effective tax rates.

Tax Status	Income Type	State Rate	+ Federal Rate	+ Medicare	- Combined Rate
Regular Tax	Short-Term Gains or Ordinary Income	13.3%	37.0%	3.8%	54.1%
Regular Tax	Long-Term Gains or Dividends	13.3%	20.0%	3.8%	37.1%
Alternative Minimum Tax	Short-Term Gains or Ordinary Income	13.3%	28.0%	3.8%	45.1%
Alternative Minimum Tax	Long-Term Gains or Dividends	13.3%	20.0%	3.8%	37.1%

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COMBINED STATE & FEDERAL INCOME TAX RATES FOR 2018

Notes & Methodology

State Only	S/T & Ord Regular	L/T & Div Regular	S/T & Ord AMT	L/T & Div AMT	
5.0%	Alabama	45.8%	28.8%	36.8%	28.8%
0.0%	Alaska	40.8%	23.8%	31.8%	23.8%
4.5%	Arizona	45.3%	28.3%	36.3%	28.3%
6.9%	Arkansas*	47.7%	27.3%	38.7%	27.3%
13.3%	California	54.1%	37.1%	45.1%	37.1%
4.6%	Colorado	45.4%	28.4%	36.4%	28.4%
7.0%	Connecticut	47.8%	30.8%	38.8%	30.8%
6.6%	Delaware	47.4%	30.4%	38.4%	30.4%
0.0%	Florida	40.8%	23.8%	31.8%	23.8%
6.0%	Georgia	46.8%	29.8%	37.8%	29.8%
8.3%	Hawaii	49.1%	32.1%	40.1%	32.1%
7.4%	Idaho	48.2%	31.2%	39.2%	31.2%
3.8%	Illinois	44.6%	27.6%	35.6%	27.6%
3.3%	Indiana	44.1%	27.1%	35.1%	27.1%
9.0%	Iowa	49.8%	32.8%	40.8%	32.8%
4.6%	Kansas	45.4%	28.4%	36.4%	28.4%
6.0%	Kentucky	46.8%	29.8%	37.8%	29.8%
6.0%	Louisiana	46.8%	29.8%	37.8%	29.8%
7.2%	Maine	48.0%	31.0%	39.0%	31.0%
5.8%	Maryland	46.6%	29.6%	37.6%	29.6%
12.0%	Massachusetts*	52.8%	35.8%	43.8%	35.8%
4.3%	Michigan	45.1%	28.1%	36.1%	28.1%
9.9%	Minnesota	50.7%	33.7%	41.7%	33.7%
5.0%	Mississippi	45.8%	28.8%	36.8%	28.8%
6.0%	Missouri	46.8%	29.8%	37.8%	29.8%
6.9%	Montana	47.7%	30.7%	38.7%	30.7%
6.8%	Nebraska	47.6%	30.6%	38.6%	30.6%
0.0%	Nevada	40.8%	23.8%	31.8%	23.8%
0.0%	New Hampshire	40.8%	23.8%	31.8%	23.8%
9.0%	New Jersey	49.8%	32.8%	40.8%	32.8%
4.9%	New Mexico	45.7%	28.7%	36.7%	28.7%
8.8%	New York	49.6%	32.6%	40.6%	32.6%
12.7%	New York City	53.5%	36.5%	44.5%	36.5%
5.8%	North Carolina	46.6%	29.6%	37.6%	29.6%
2.9%	North Dakota*	43.7%	25.9%	34.7%	25.9%
5.0%	Ohio	45.8%	28.8%	36.8%	28.8%
5.0%	Oklahoma	45.8%	28.8%	36.8%	28.8%
9.9%	Oregon	50.7%	33.7%	41.7%	33.7%
3.1%	Pennsylvania	43.9%	26.9%	34.9%	26.9%
6.0%	Rhode Island	46.8%	29.8%	37.8%	29.8%
7.0%	South Carolina*	47.8%	27.7%	38.8%	27.7%
0.0%	South Dakota	40.8%	23.8%	31.8%	23.8%
0.0%	Tennessee	40.8%	23.8%	31.8%	23.8%
0.0%	Texas	40.8%	23.8%	31.8%	23.8%
5.0%	Utah	45.8%	28.8%	36.8%	28.8%
9.0%	Vermont	49.8%	32.8%	40.8%	32.8%
5.8%	Virginia	46.6%	29.6%	37.6%	29.6%
0.0%	Washington	40.8%	23.8%	31.8%	23.8%
6.5%	West Virginia	47.3%	30.3%	38.3%	30.3%
7.7%	Wisconsin*	48.5%	29.2%	39.5%	29.2%
0.0%	Wyoming	40.8%	23.8%	31.8%	23.8%
9.0%	Washington DC	49.8%	32.8%	40.8%	32.8%

Notes
Chart shows highest marginal tax bracket.

Massachusetts: Short-term & ordinary rate applies only to short-term gains, not ordinary income, which is taxed at the same rate as long-term gains.

New Hampshire: No state income tax on capital gains; tax on interest and dividends.

Tennessee: No state income tax on capital gains; tax on interest and dividends.

(*) Different state tax rates for short- and long-term gains.

Sources
The Federation of Tax Administrators
www.taxadmin.org/assets/docs/Research/Rates/ind_inc.pdf

CCH 2017 State Tax Handbook
www.cchgroup.com/store/products

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Aperio tax guide now updated.

Alternative Minimum Tax

	Regular	AMT	Difference
2017	State income tax deductible against federal liability	No deduction for state income tax	Significant
2018	No deduction for state income tax*	No deduction for state income tax	None

- Some AMT taxpayers will shift from AMT to regular rates
- Rates on S/T gains could rise 9 percentage points
- For former payers of AMT, no change for L/T gains

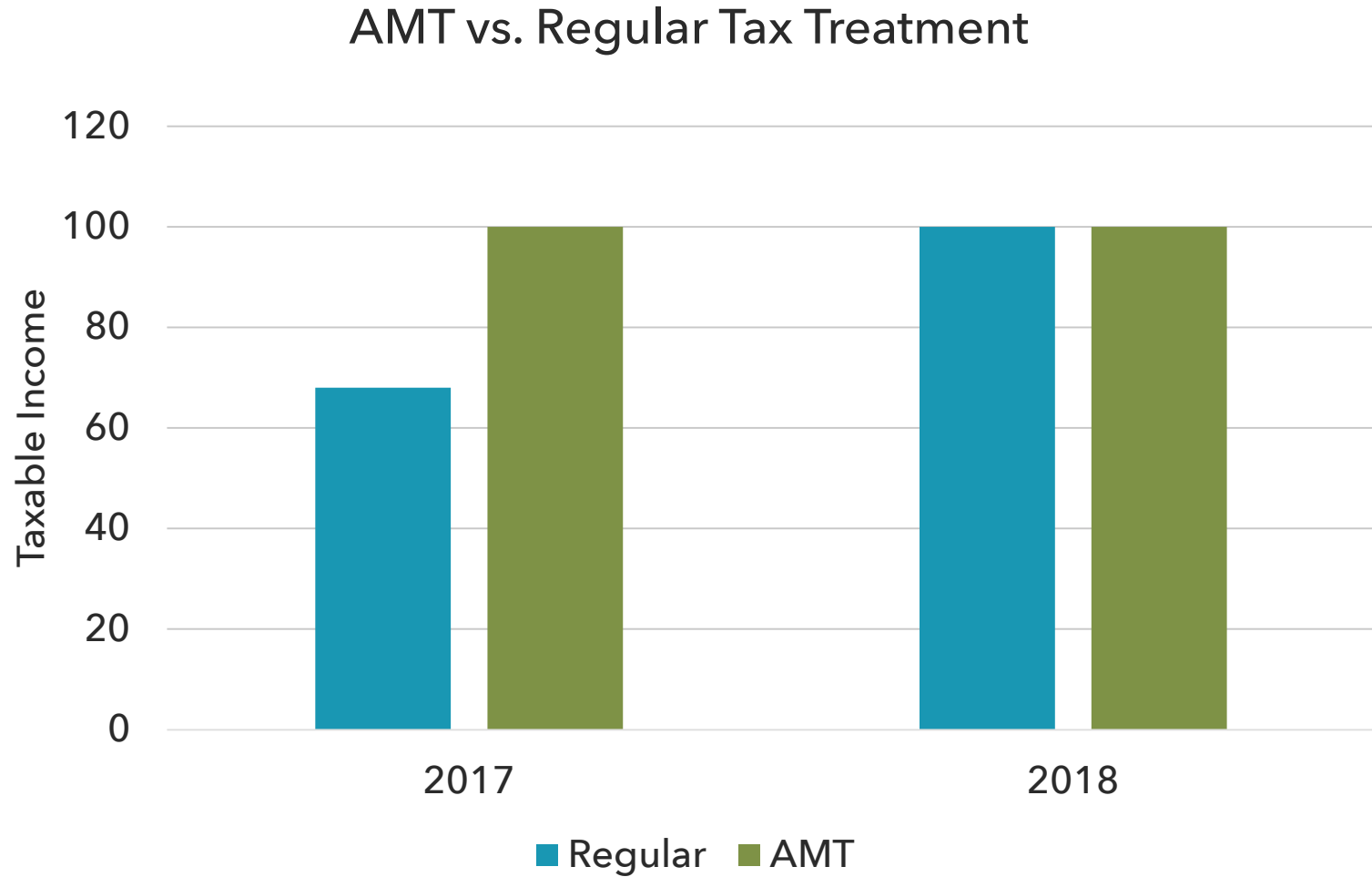
*Comparison reflects incremental tax for high-bracket taxpayers who have already surpassed the \$10,000 limit on state and local taxes.

Alternative Minimum Tax, Example

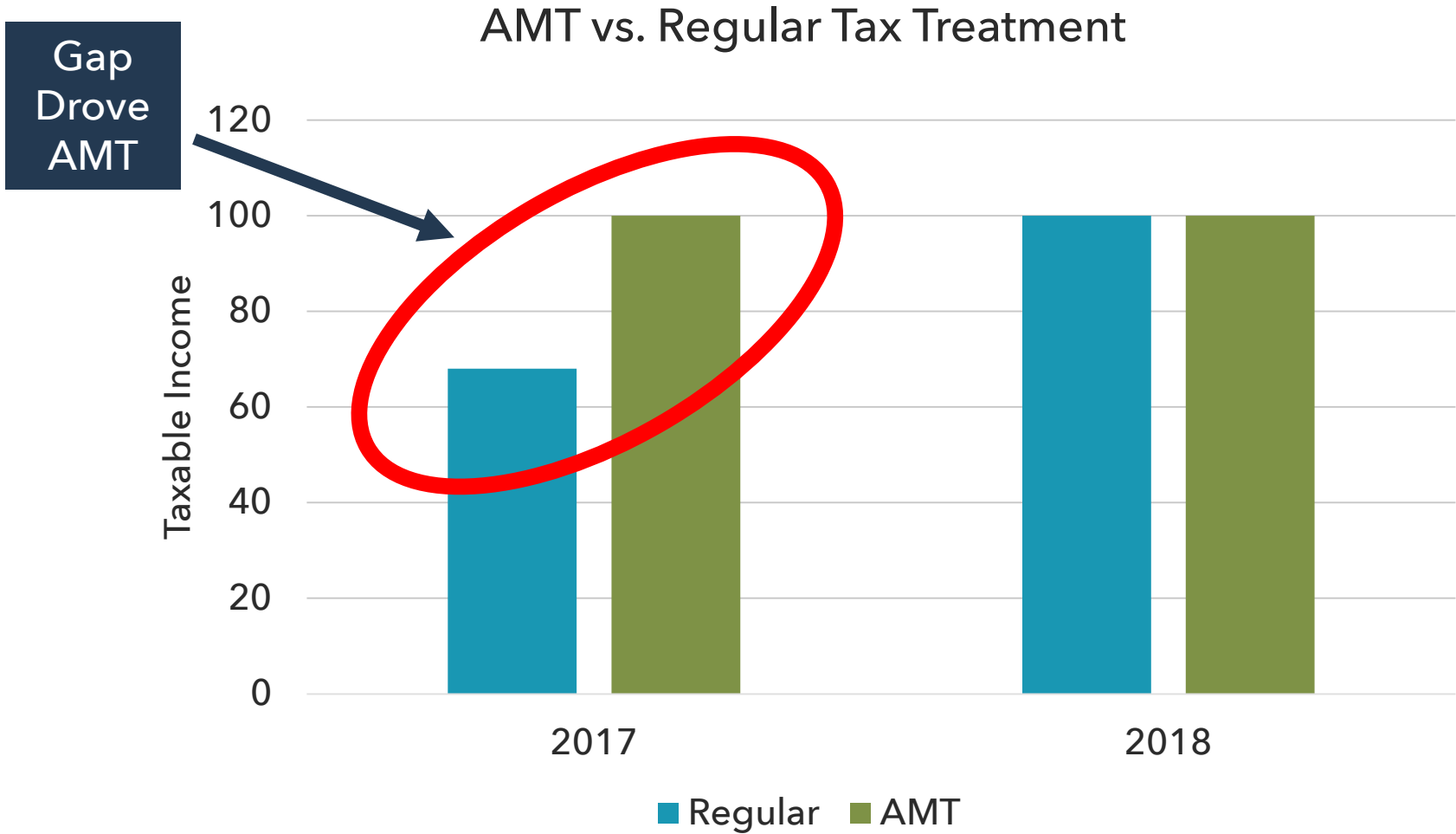
	Old Regular	Old AMT	New Regular	New AMT
Income	100	100	100	100
Less State Tax, Property & Misc.	-32	0	0	0
Taxable Income	68	100	100	100
Tax Liability	27	28	37	28
Rate	39.6%	28.0%	37.0%	28.0%

Shown above is an extreme example to illustrate the impact of the change in AMT preference items versus regular tax.

Alternative Minimum Tax



Alternative Minimum Tax



Investors No Longer Subject to AMT

Marginal Federal Liability	Old (AMT)	New (Regular)	Difference
Ordinary income or short gains	28.0%	37.0%	+9.0 pp
Long gains	20.0%	20.0%	0.0 pp

Questions to Ask Your Accountant

- If I'm subject to AMT in 2017, will I face AMT in 2018?
- If so, which 2018 preference items remain?
- Some remaining preference items
 - Incentive stock options
 - Private activity bonds (type of municipal bond)
 - Certain depreciation
- Major preference items no longer relevant
 - State tax
 - Miscellaneous deductions
 - Property tax

Key Takeaways

- Rate changes depend on state
- AMT itself may not change much, but the differences between AMT and regular have changed enormously
- Fewer taxpayers will be subject to AMT
- Some analysis and press coverage missing the nuance

Conventional Wisdom	More Nuanced Version
"Tax rates declining for top-bracket taxpayers."	For taxpayers in states with high tax rates, overall taxes are rising
"AMT isn't changing much, except for exemptions and phase-outs."	AMT rules may look similar, but the difference with regular reflects a big change, which may mean higher rates on short-term gains.

Changes to Aperio's Processes

- Updated tax guides
- Performance reporting
- Portfolio rebalancing
- Clients may need to change rates in our system
 - Custom rates provided by client
 - Clients who have selected AMT may need to confirm
- Research will update economics of harvesting

Disclosure

The information contained within this presentation was carefully compiled from sources Aperio believes to be reliable, but we cannot guarantee accuracy. We provide this information with the understanding that we are not engaged in rendering legal, accounting, or tax services. In particular, none of the examples should be considered advice tailored to the needs of any specific investor. We recommend that all investors seek out the services of competent professionals in any of the aforementioned areas.

With respect to the description of any investment strategies, simulations, or investment recommendations, we cannot provide any assurances that they will perform as expected and as described in our materials. Past performance is not indicative of future results. Every investment program has the potential for loss as well as gain.

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Tax rate calculations reflect highest bracket for federal rates from <https://www.congress.gov/bill/115th-congress/house-bill/1/text>, which reflects changes from the Tax Cuts and Jobs Act of December 2017. State rates sourced from *CCH 2017 State Tax Handbook*.