Insight

The Tax Cuts and Jobs Act in the Financial Services Industry

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Today the House Ways and Means Committee released its proposed bill for tax reform, the Tax Cuts and Jobs Act. Among its provisions are several that relate directly to the financial services industry and affect both the companies and the consumers affiliated with those products. Below is a brief analysis of some highlights of what is included in the bill and how it may affect those parties.

1. Savings, Pensions, and Retirement

a. Repeal of a rule permitting recharacterization of Roth IRA contributions as traditional IRA contributions

Currently, retirement savers can recharacterize contributions to a Roth IRA as contributions to a traditional IRA and vice versa. Recall, that contributions to a Roth IRA are taxed when the contribution is made and not when the funds are withdrawn whereas a traditional IRA is not taxed when a contribution is made but is taxed when funds are withdrawn.

This ability to recharacterize their contributions allows some retirement savers to take advantage of the tax benefits of a Roth IRA if the account sees gains, but convert back to a traditional IRA if the account suffers loss. By repealing the ability to recharacterize IRAs without consequence, the bill would prevent this gaming of the system and would appropriately collect taxes on Roth and traditional IRAs as intended.

The Joint Committee on Taxation (JCT) estimates that this repeal would increase tax revenue by $500 million over 2018-2027.

b. Reduction in minimum age for allowable in-service distributions

Currently, retirement savers who use defined contribution plans are not allowed to withdraw funds from those plans until they are at least 59.5 years old or when they retire, while for state and local plans and defined benefit plans, that minimum age is 62. As a result, many participants in these plans decide to retire early (before 62) instead of continuing to work because that is the only way they will have access to their funds.

The bill would allow for in-service distributions from these defined contribution and defined benefit plans starting at age 59.5, making the distribution ages uniform and encouraging taxpayers to continue to work full or part time instead of retiring early just to be able to access their savings.

The JCT estimates that this provision would increase tax revenue by $13.1 billion over 2018-2027.

c. Modification of rules relating to hardship withdrawals from cash or deferred arrangements

Currently, participants in defined contribution plans cannot make in-service withdrawals until they are 59.5

years old (see above) unless they are making a hardship withdrawal. However, participants can only make a hardship withdrawal from their own personal contributions, not those from the employer or any earnings or interest.

The bill would allow hardship withdrawals to be made from all funds in a plan, including the earnings, interest, and employer contributions, providing greater access to defined contribution plan funds in case of an emergency.

The JCT estimates that this provision would increase tax revenue by $700 million over 2018-2027.

d. Extended rollover period for the rollover of plan loan offset amounts in certain cases

Currently, participants in defined contribution plans are allowed to withdraw from their plan funds and treat this withdrawl as a loan. However, if the employee does not follow certain rules applicable to plan loans, that loan from the plan is then treated as a taxable distribution, potentially triggering the 10 percent penalty for early withdrawal. If either the plan terminates or the employee leaves that employer, they then have 60 days to transfer the loan balance to an individual retirement account (IRA) before it's treated as a taxable distribution. The harsh timeline often hurts individuals who lose their job or are going through otherwise difficult financial situations.

The bill would remove the 60-day window. Instead, employees who take a plan loan and then either lose their job or their plan could wait until their tax filing deadline to contribute their loan amount to an IRA.

The JCT estimates that this provision would have a negligible tax revenue effect.

2. Financial Instruments

a. Termination of tax-exemption on private activity bond interest

Currently, earned interest on both government bonds and private activity bonds is not included in one's income and thus is exempt from tax. Government bonds are generally used to fund projects that result in public goods, while private activity bonds are used to fund any number of private party interests, such as mortgages and student loans. Private activity bonds are subject to a per-state volume cap, which for 2017, is the greater of (1) $100 multiplied by the particular state's population, or (2) $305,315,000.

This tax-exempt interest on private activity bonds means that the federal government is, in effect, subsidizing the borrowing of private businesses and individuals. The bill would repeal the tax exemption for public activity bonds and would include any interest earned from a public activity bond in one's annual income, thus subjecting it to income tax. This new provision would not apply to any bonds already issued; rather, it would only apply to newly issued bonds.

The JCT estimates that this provision would increase tax revenue by $38.9 billion over 2018-2027.

b. Repeal of advance refunding bonds

Currently, any interest earned on bonds that are used to pay principal, interest, or redemption prices on a previously issued bond is generally not taxable. A current refunding is made when the refunded bond is redeemed within 90 days of issuance of the refunding bond, whereas advanced refunding is made when the

refunded bond is redeemed more than 90 days after the issuance of the refunding bond. While current refunding of private activity bonds is not taxable, advance refunding, in contrast, is taxable.

With this disparate treatment, state and local governments are incentivized to issue two separate sets of federally subsidized bond debt to finance the same activity. The bill would tax the interest on all advance refunding bonds, but interest on current refunding bonds would remain tax exempt.

The JCT estimates that this provision would increase tax revenue by $17.3 billion over 2018-2027.

c. Repeal of tax credit bonds

Currently, state and local governments can issue tax credit bonds to finance projects, and the holders of those bonds receive a tax credit either fully or partially in lieu of interest payments on the bond. For some types of tax credit bonds, the authority to issue has expired and the volume cap has been reached. However, for other types, the authority still exists and the volume cap has not yet been reached. The bill would repeal all rules relating to tax credit bonds. Those already holding the bonds would continue to receive their credits and payments, but no new bonds would be issued.

The JCT estimates that this provision would increase tax revenue by $4.5 billion over 2018-2027

3. Insurance Companies

a. Net operating losses of life insurance companies

Currently, net operating losses for businesses may be carried back by up to two tax years or carried forward up to 20 tax years. However, for life insurers, they may be carried back by up to three tax years or carried forward by up to 15 tax years. The bill would equalize this difference, allowing life insurers to carry net operating losses back two years and forward 20 years like other businesses.

The JCT does not give an individual estimate to this provision as it relates specifically to life insurers, but it does give an estimate for all modifications of net operating loss deductions included in the bill. All of these provisions would increase tax revenue by $156 billion over 2018-2027.

b. Repeal of small life insurance company deduction

Currently, life insurers can deduct 60 percent of their first $3 million of life insurance related income, but that deduction is phased out for companies with incomes between $3 and $15 million and does not exist for life insurers with assets of $500 million or more. This deduction has been viewed as a tax subsidy for a particular segment of an industry that is not available for others in that industry or businesses in other industries.

The provision would repeal the deduction for small life insurance companies under $3 million and those between $3 million and $15 million in its entirety.

The JCT estimates that this provision would increase tax revenue by $200 million over 2018-2027.

c. Computation of life insurance tax reserves

Currently, life insurers can deduct net increases in their reserves from their gross income, but must include net decreases. The statutory computation of these changes in reserves is a complicated process which varies by state, and at times it understates income. The bill would provide life insurers with a specific percentage (76.5 percent) to use to take into account the change in reserves for future un-accrued claims in calculating their taxable income. Deficiency reserves, asset adequacy reserves, or other types of reserves would not be included in the calculation.

The JCT estimates that this provision would increase tax revenue by $14.9 billion over 2018-2027.

d. Capitalization of certain policy acquisition expenses

Currently, life insurers are required to spread out over ten years the expenses associated with earning a stream of premium income, rather than deducting it immediately. The expenses that are required to be spread reflect expense ratios for three broad categories and are the lesser of (1) a specified percentage of the net premiums received on each of a company's three categories of insurance contracts; or (2) the company's general deductions. For annuity contacts, the specified percentage is 1.75 percent; for group life insurance contracts, it's 2.05; and for all other specified insurance contracts, it's 7.7.

The bill would update the categories of contracts and the percentages of expenses required to be spread to reflect more up to date expense ratios for insurance products. The three categories (annuities, life insurance contracts, and all other) would be updated to be two categories: (1) group contracts covering a group of connected individuals, and (2) all other specified contracts. The updated percentages would be 4 percent and 11 percent respectively.

The JCT estimates that this provision would increase tax revenue by $7.0 billion over 2018-2027.

4. Mortgage Interest

The bill retains a mortgage interest deduction, but limits it to new loans on homes used as the principal residence of the owner and only up to $500,000 of the mortgage principal. This cuts in half the previously allowed mortgage interest deduction which allowed up to $1 million of the mortgage principal. This will affect homeowners, especially in areas with high costs of living like New York, San Francisco, and Washington, D.C., where even middle-class families are purchasing homes well in excess of $500,000. The change does not affect existing mortgages.

In 2016, the JCT estimated that $77 billion in tax expenditures came from the mortgage interest deduction. By cutting the allowable limit in half, tax revenues should increase significantly as a result.

5. Capital Gains

Tax treatment of capital gains remains unchanged at 23.8 percent. However, the bill eliminates the ability to exclude from taxable income capital gains from the sale of a primary residence for high income earners (over $500,000 filing jointly or $250,000 singly filer). It also tightens the ability of lower income earners to exclude those capital gains by requiring the taxpayer to own and use the home as their principal residence for five of the eight previous years to qualify for the exclusion.

The JCT estimates that this provision would increase tax revenue by $22.4 billion over 2018-2027.

6. Limitation on deduction for FDIC premiums

Currently, banks are able to deduct as a business expense any amount paid to the Federal Deposit Insurance Corporation (FDIC) to support the Deposit Insurance Fund (DIF), pursuant to an assessment by the FDIC. The bill would limit those amounts allowed to be deducted for banks with assets greater than $10 billion. As a bank's assets grow beyond $10 billion, the bank cannot deduct a proportion of its FDIC payment equal to 1) the amount that its assets exceed $10 billion 2) over $40 billion. So, if a bank has $20 billion in assets, it cannot deduct 25 percent of its FDIC payment. Similarly, if the bank has $50 billion in assets (or more), it cannot deduct any of its FDIC payment.

The JCT estimates that this provision would increase tax revenue by $13.7 billion over 2018-2027.