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New Tax Act Changes Require a Financial Checkup

In December 2017 Congress signed a wide-ranging tax bill called The Tax Cuts and Jobs Act (TCJA) which made significant changes to the way Federal taxes are calculated. The new law changed tax rates and tax brackets, eliminated many deductions and added others, altered the way small businesses will be taxed, dramatically lowered the corporate tax rate to 21%, and provided many new rules and opportunities for individuals and businesses to maximize tax planning.

The new tax changes can be quite beneficial for those with sizeable incomes and assets. Therefore, it is necessary to work with your financial advisor and tax accountant soon to review your current financial condition, goals, and intentions while there is still time left in the year to make changes.

Our desire is to help you review the complex changes in the tax laws and help you coordinate with other experts to construct an optimal path forward. As a financial advisor and investment manager, our function is to cooperate with your tax advisers and attorneys to make sure that your goals are being met, and that the recommendations fit your unique needs. Such coordinated discussions can help you make educated decisions involving tax returns, adjustments to wills, trusts, and life insurance, and planning for your family's long-term well-being.

Let's begin with some general comments about the new tax law.

General Observations About the TCJA

- 1) It's the most far-reaching and complex tax reform since 1986.
- 2) It impacts nearly every person and every business.
- 3) Many people will see a net positive to their bottom line.
- 4) Interpretation and revision of the rules will continue.
- 5) Most individual changes are temporary and will expire after 2025 unless altered by



Source: 123rf.com

Congress. The business-related changes don't expire.

- 6) It adds an estimated \$1.8 trillion to the national deficit over ten years.
- 7) It was not passed with bipartisan support, unlike previous big tax revisions.

Four Key Areas of Difference in the TCJA

- 1) Many deductions have been eliminated and some have been reduced. These changes will require your attention.
- 2) Where you live and where you die will make a difference to the amount of taxes you or your heirs could owe.
- 3) A wide range of family tax issues are raised by this new tax bill. Such as the altered deductibility of each child, how your children's education is funded, changes to the marital deduction, rules affecting the tax treatment of various retirement plans (401(k), Roth IRA, pension, or IRA), and especially the much greater limits on the value of an estate not subject to estate tax.
- 4) Businesses and small business owners face a wide range of rule changes, many of which are extremely complicated and will require expert advice and planning. However, a potential benefit of the TCJA is a new deduction equal to 20% of "qualified business income" if specific conditions are met. We will elaborate on page four.

Now we will look at the details of some of the tax law's rule changes.

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The New Tax Tables

Exhibit 1 displays the new tax tables for single and joint married filers. There are still seven brackets but on average, most taxpayers will pay approximately 2-4% less than they did in 2017 on the same amount of income. Other noteworthy observations are:

- 1) The highest Federal tax rate of 39.6% has been reduced to 37%.
- 2) Higher income earners will see more of a reduction than lower earners. On average, filers with income over \$200,000 will save 3-4%. Filers with income between \$30,000 and \$200,000 will save 1-2%.¹
- 3) Lower taxes paid to the IRS means that households will have more money to spend, save, or invest.
- 4) You may need to adjust (lower) your withholding amounts in order to not overpay estimated taxes.

The IRS assumes that there will be additional changes made by Congress between now and 2019 which may require further adjustments by taxpayers. An example is the “indexation” of capital gains. The Treasury Department is researching whether the Executive Branch has sufficient authority to make this adjustment without approval from Congress.

Note 1: <https://www.npr.org/2017/12/19/571754894/charts-see-how-much-of-gop-tax-cuts-will-go-to-the-middle-class>

Other Major Changes Affecting Tax Planning

Exhibit 2 illustrates the significant increase in the standard deduction. As a result of this doubling, the number of people taking the standard deduction in the U.S. is expected to go from 68% of returns filed to 90% of returns!

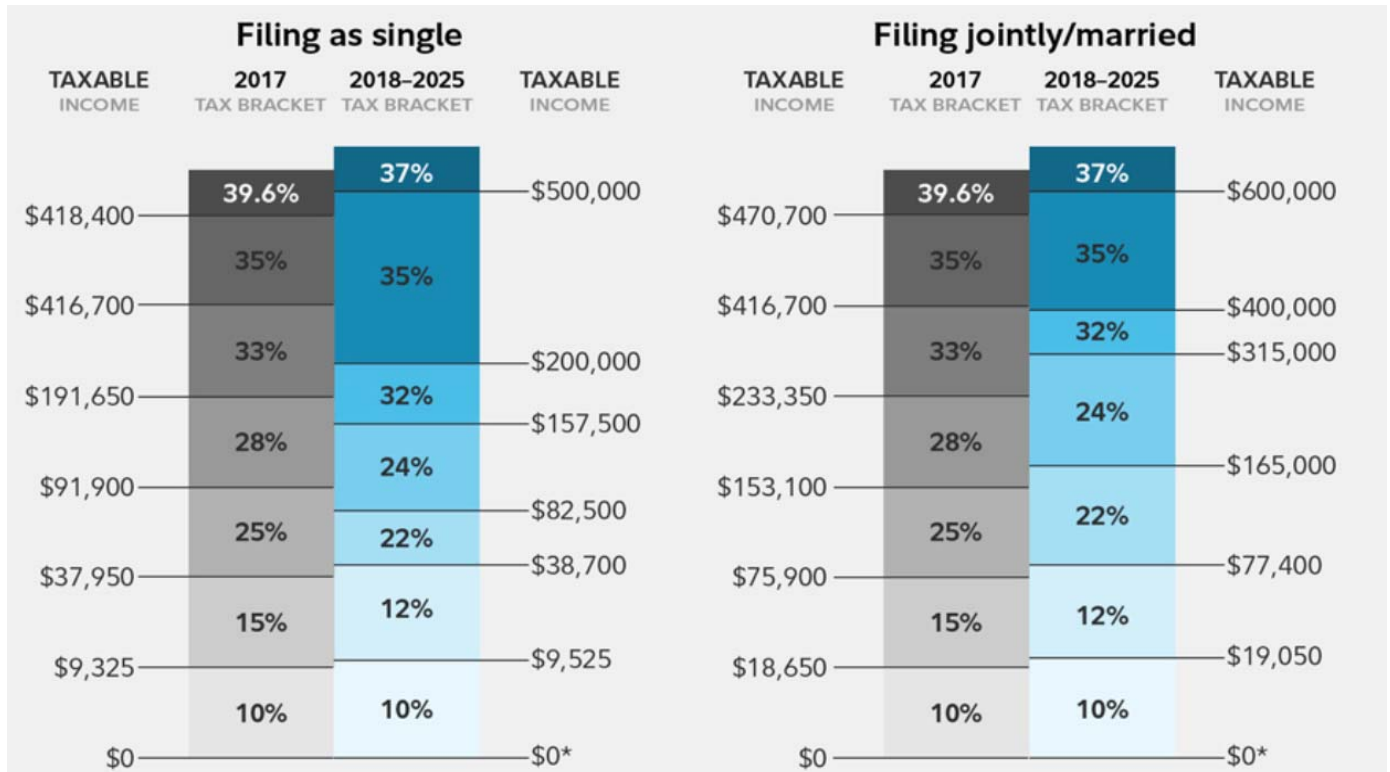
Another reason many will take the new standard deduction is because (as illustrated in Exhibit 3) many deductions are being eliminated or greatly curtailed. For example, the deduction for state and local taxes, along with property taxes, and sales taxes in the aggregate is now capped at a total of \$10,000. In states with an income tax, this restriction is meaningful.

Exhibit 2: Changes to the Standard Deduction

		2017	2018-2025
Standard deductions	Single	\$6,350	\$12,000
	Married filing jointly (MFJ)	\$12,700	\$24,000
	Elderly or blind (single and not a surviving spouse)	Additional \$1,550	Additional \$1,600
	Elderly (both over age 65 and MFJ)	Additional \$2,500	Additional \$2,600
Exemption	Personal exemption	\$4,050 per family member	Eliminated

Source: Fidelity, IRS

Exhibit 1: The New Tax Brackets



*Chart does not account for the Medicare surtax on high earners. Source: House of Representatives, Tax Cuts and Jobs Act, December 22, 2017
Source: Fidelity, IRS

A Summary of Exhibit 3

The 2017 Tax Cuts and Jobs Act is the broadest change in the tax landscape since 1986. Many former deductions have been eliminated or reduced. Exhibit 3 lists the bulk of the changes. There are so many we can't list them all, but here are a few major changes.

- 1) The child credit went up to \$2000 for each child under the age of 17.
- 2) The new mortgage interest deduction is capped at the interest paid on a \$750,000 mortgage. Filers will be allowed to continue deducting interest on existing mortgages, as long as the mortgage value is under \$1 million.
- 3) The charitable gift allowance was raised to 60% of adjusted gross income (AGI) vs. 50% under the old code.
- 4) Given the new larger standard deduction, many filers will bunch as many deductions as possible into one year, and then take the standard deduction in the next year. It will take careful planning to make that work.
- 5) As can be seen in the far right column, many previously allowed deductions have been eliminated. Some examples are: moving expenses, home equity loan interest (except where the loan is used for substantial improvements to the property), casualty and theft, alimony, and many miscellaneous expenses.

Business Taxes and Estate Planning Are Greatly Affected By The New Tax Laws

Perhaps the most wide-ranging and influential section of the new tax act is applied to business taxation. Many small to medium-sized businesses are run by individuals who may have started their businesses and have by now accumulated some wealth. The new business tax changes have positive applications for further maximizing wealth. And, if such an individual or individuals have not taken the time to establish an estate plan, the new tax laws provide considerable incentive to do so.

The four most important changes to business taxes are:

- 1) The new top tax rate is now 21% vs. the previous 39.6%. The new rate applies to C and S corporations as well as LLCs, sole proprietorships, and partnerships.
- 2) The TCJA eliminates the Alternative Minimum Tax (AMT) for business.
- 3) A new 20% deduction is available for business owners who don't pay the corporate tax. We will discuss this in greater detail below.
- 4) Small businesses will now be able to expense more property and equipment up front than before.

Exhibit 3: Other Tax Changes, Adds and Eliminations

	2017	2018-2025
Dependent credit (other than child)	N/A	\$500 credit per qualifying dependent
Child/dependent tax credit	\$1,000 credit per qualifying child < age 17 (modified adjusted gross income [MAGI] limit \$110,000 MFJ/\$75,000 single)	\$2,000 credit per qualifying child < age 17 (MAGI limit \$400,000 MFJ/\$200,000 single)
Moving expenses	Deductible (move >50 miles for a new job)	Eliminated
State and local taxes	Deductible (property and sales or income tax)	Capped at \$10,000 of expenses (property and sales or income tax, regardless of filing status)
Mortgage interest	Limited to interest on \$1,000,000 of debt on primary or secondary home	Limited to interest on \$750,000 of debt on primary or secondary home (no change for existing mortgages)
Home equity loan interest deduction	Limited to interest on \$100,000 of debt	Eliminated (does not apply to home equity loans for substantial home improvements that comply with debt limit)
Medical expense deduction	Deductible if >7.5% of AGI	No change for 2018 >10% of AGI 2019-2025
Casualty and theft	Deductible if >10% of AGI	Eliminated (except in the case of federally recognized natural disaster)
Alimony	Deductible by the payer; taxable to the payee	The deduction for the payer is eliminated; the recipient is no longer taxed
Investment interest expense	Deductible up to the amount of net investment income	Unchanged
Miscellaneous expenses,	Deductible in excess of 2% of AGI	Eliminated
Charitable gifts	Limited to 50% of AGI	Raised to 60% of AGI

Source: Fidelity, IRS

The 20% Deduction on Qualified Business Income

Examples of businesses eligible for the 20% deduction are: partnerships, sole proprietorships, S corporations, and limited liability companies (LLCs). Commonly called “pass-through” businesses, these owners have been paying income tax at the 2017 rate for individuals (or married filing jointly). However, to qualify for the 20% deduction, the income must be “Qualified Business Income (QBI)” as defined by IRS rules. The definition of QBI is complicated.

A determination of what is QBI will require additional help from a tax accountant. For example, excluded from qualified income is the income of many professional service providers such as: lawyers, doctors, dentists, and other service based providers where only one individual provides the service (such as a baker). Additionally, the calculation of how much of a deduction you can take can be affected by the number of employees.

CPA firms are currently in discussion with the IRS asking for clarification and for possible changes to the description or rulings. Here is the latest from the IRS website:

“For taxable years beginning after December 31, 2017, taxpayers other than corporations may be entitled to a deduction of up to 20 percent of their qualified business income from a qualified trade or business under the Tax Cuts and Jobs Act. This deduction can be taken in addition to the standard or itemized deductions. The deduction is subject to multiple limitations based on the type of trade or business, the taxpayer’s taxable income, the amount of W-2 wages paid with respect to the qualified trade or business, and the unadjusted basis of qualified property held by the trade or business. Notwithstanding these limitations, however, taxpayers with qualified business income (which does not include income from performing services as an employee) and with taxable income under \$157,500, or \$315,000 for joint returns, will generally be eligible for the deduction. The IRS will provide additional information and guidance on this deduction later this summer.”
<https://www.irs.gov/newsroom/new-deduction-for-qualified-businesses>

An Estate Tax Checklist

One of the most notable changes in the Federal Estate tax law is the doubling of the size of the exclusion. Until December 31, 2017, the amount of value excluded was \$5.6 million for one person, and \$11.2 million for married couples. This amount doubled with the new tax law and is now \$11.2

million for one person, and \$22.4 million for a married couple. This large change created a need to update estate plans. Please note that the State of Washington exemption for estate taxes is still \$2.193 million per person. Here is a checklist of items to consider:

- 1) Is there an updated Will, and does it take into account the new excluded amounts?
- 2) Are each of the Trusts and beneficiaries identified properly with the desired inheritances and properties?
- 3) Do you have an active Power of Attorney document and a relevant Health Care Directive?
- 4) In 2018, the IRS allows an unlimited number of gifts of \$15,000 to be granted tax free to family members or relevant people (up to the value of the estate).
- 5) Do you still need life insurance, since many policies were designed to pay the estate tax? You may want to change the beneficiaries and their allocations.
- 6) Are you sure you want to live and/or die in your current state of residency? Each state has unique taxation policies with regard to inheritances and estates.
- 7) Formulas used in previous estate documents could have the effect of cutting out your children or your surviving spouse. Revisit your documents to make sure they still reflect your wishes.

These and numerous other issues suggest that it is timely to review with your financial adviser, CPA, and estate attorney the new rules that could affect your family legacy.

The Personal Tax Cuts Are Not Permanent

Congress designed the personal tax cuts to expire. After 2025, the personal tax schedules revert back to 2017’s levels and rules. Congress is likely to address this as we approach 2025. The business tax cuts will remain in place after 2026. We also expect Congress to make additional changes over time, both corrections and additions.

The new tax laws are complex and impact each individual differently depending on income, the state of residency, and family size. This added complexity produces many interacting parts and alters dynamically the impact of many investment decisions. Decisions such as how to structure a portfolio, the timing of purchases and sales, how much capital gains to take (and when), and how much of your assets you want to personally enjoy vs. give to others.

It is time to have a detailed conversation.

MARKET STATS	
S&P 500	2816
DOW JONES	25415
10 YR T-BOND	2.95%

As of 07/31/2018

Source: Bloomberg

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