Creative
wealth maximization strategies*

2018 / V052018

TAXES: The Obvious and Not-So-Obvious

In the wake of the greatest shift in tax policy in 30 years, financial professionals are scrambling to assess the impact of the changes which went into effect on January 1, 2018. In general, the new tax plan lowers tax rates while eliminating or decreasing deductions. But many households won't know if the changes improve or worsen their tax status until the year ends, and a return is filed.

Then the ripple effects will begin, because every tax produces unintended consequences. The challenge for tax planners is to connect the obvious and immediate impacts with not-so-obvious and usually unforeseen ripple effects.

More and Less...but of What?

President Reagan was fond of repeating this simple explanation for how taxes affect the economy: **"If you want more of something, subsidize it. If you want less, tax it."**

Deductions from taxable income are subsidies. When deductions are eliminated, it is the same as imposing, or increasing, taxes. But when you decrease tax rates ***and*** deductions, what will happen? Considering history, the answers could be interesting.

Will High-Income Homeowners Mow Their Lawns?

On personal returns, all households will receive a significantly higher standard deduction. But the increased exemption is paired with lower limits for itemized deductions, particularly for homeowners. The limits for deductible mortgage interest are reduced, and the amount of state and local taxes, including property taxes that can be taken as additional deductions, is capped at $10,000. This shift is significant. A February 2018 analysis from Zillow estimates that "only about 14% of homeowners, down from 44%, will claim the mortgage interest deduction next year."

For lower- and middle-income homeowners, the new standard deduction may exceed their previous itemized deductions for home ownership, with a net effect of less taxable income. But those with higher incomes, who previously received tens of thousands of dollars in deductions for large mortgages on homes in communities with high property taxes, could find themselves in a curious reversal: in a lower marginal tax bracket, but with more taxable income.

The Obvious: For high-income households, the cost of owning a large home and living in a community with high property taxes is now greater.

A possible, not-so-obvious ripple effect: Landscapers go out of business?

Remember, ripple effects are not immediately apparent, so this is a hypothetical. But suppose the decrease in housing and property tax deductions results in a household with an adjusted gross income of $350,000 paying an additional $5,000 in income taxes. This additional tax probably doesn't cause the homeowners to consider selling and moving to a less-expensive home. But it could certainly affect how much is spent on landscaping and lawn care. Maybe the family cuts the grass

>> CONTINUED

* The title of this newsletter should in no way be construed that the strategies/information in these articles are guaranteed to be successful. The reader should discuss any financial strategies presented in this newsletter with a licensed financial professional.

Pub 6357 (05/18)
2018-57837 Exp 4/2020

TAXES: THE OBVIOUS AND NOT-SO-OBVIOUS

>> CONTINUED

themselves, or puts up a canvas canopy instead of having a deck built. With money that could have paid landscapers and lawn care now going to the IRS, these small companies will either be less profitable, or worse, out of business.

Golf Gets Sliced Out?

A similar exchange of lower rates and fewer deductions affects business taxes as well. Entertaining customers, clients and other business contacts has long been essential to developing relationships and getting deals done. Now, many of these "costs of doing business" are no longer deductible.

While no change was made to the 50% deduction for business meals, the new rules eliminate the deductibility for many other business-related entertainment expenses, such as: the cost of tickets to sporting events, license fees for stadium or arena seating rights, private boxes at sporting events, theater tickets, golf club dues, company golf outings for customers, hunting, fishing and sailing outings, etc. In short, a lot of corporate perks are no longer subsidized.

The Obvious: For businesses, the cost of entertaining clients and prospective customers has gone up.

A possible, not-so-obvious ripple effect: Golf dies out?

In both the personal and business examples, the loss of subsidy results in higher costs – for owning a home, or operating a business. The logical response is to reduce other operating costs, especially costs that are seen as non-essentials, like entertainment.

"Consider that you just saw the cost of (business) golf double," says David Rynecki, CEO of a research company that follows the recreation industry. "It will definitely cause more scrutiny of corporate outings." In a sport where participation is already declining because of the high cost of equipment and the time it takes to play, making golf twice as expensive for businesses is not going to improve the sport's prospects for attracting younger generations.

Taxes on Trees and Windows

Maybe the decline of lawn care and death of golf seems over the top. But history tells some strange tax tales.

In the late 18th century, the Ottoman Turks imposed a "tree tax" on the residents of Palestine, Israel and Syria. Trees were taxed for the fruit, their value as timber, even for the shade they provided.

To avoid the taxes, landowners cut down their trees, which was certainly not what the rulers expected. But beyond the loss of tax revenue, historians blame the "Ottoman Tree Tax" for causing an ecological disaster. The widespread deforestation that occurred was comparable to clear-cutting or strip mining, and today, what had once been part of the "Fertile Crescent" is barren and arid. Because of taxes.

The 17th-century English government saw windows as markers of prosperity – the more you had, the wealthier you were. In 1696, England imposed a window tax. Every building was permitted eight "tax-free" windows, but additional windows were taxed on a progressive scale. This tax remained in effect for more than 250 years.

Much like the tree tax in the Middle East, English property owners responded by getting rid of their windows. An Internet search yields a multitude of photos of existing buildings with their (still) bricked-up window wells.

Beyond the loss of curb appeal, fewer windows impacted the health and safety of the residents. Dark, poorly-ventilated dwellings, especially in densely-populated industrialized cities, were breeding grounds for disease and poor health. And fewer windows made it easier for criminals to work mischief inside buildings, and on the street. The Window Tax was finally repealed in 1851 when protesters like Charles Dickens argued that it was a tax "on health," and "on light and air."

And the takeaways are...

- Taxes impact personal finance (but you knew that)
- Taxes change frequently (and sometimes drastically)
- You should include tax professionals in your financial decisions (they may see what is not-so-obvious)