

# THE NEW FINANCIAL LONGEVITY BUNDLE®



## Universal Wealth Management, LLC

Karen Emma

945 Reservoir Avenue

Cranston, RI 02910

401.331.7600

401.331.7800

[www.universalwm.com](http://www.universalwm.com)

[info@universalwm.com](mailto:info@universalwm.com)

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## How Tax Reform Affects Your Pre-Retirement and Retirement Planning

Here are some of the ways the new Tax Cuts and Jobs Act (Tax Reform) can both directly and indirectly affect your present or future retirement plan.

### WHAT IS CHANGING?

#### 1. New Tax Brackets and Rates

Most tax rates are lower and brackets are broader. Many are positive for investors, especially in the early years, but perhaps not all years. Over time, some taxpayers could end up in higher tax brackets due to a change in the way the annual increases to the brackets are calculated. But for now, this could be a big benefit to many.

For example, in 2017 a single taxpayer with taxable income of \$40,000 would fall into the old 25 percent bracket and pays \$5,739 in taxes. The same single payer in 2018 falls into the new 22 percent bracket and pays \$4,740.

However, important to note for future years: The tax rate remains progressive: rates rise as income increases.

#### 2. Standard Deductions vs. Itemization

Early tax experts estimate a slight tax decrease for taxpayers who take of standard deductions and a slight increase for those who itemize. The new tax bill will combine the personal exemption and standard deduction into a single higher standard deduction, which will be indexed to inflation. The new standard deduction for a single person is \$12,000; for a married couple filing jointly, \$24,000.

The child tax credit increases from \$ 1,000 in 2017 to \$ 2,000 for 2018. There is also a new dependent tax credit in 2018 - \$ 500 per non-child dependent. This can apply to a number of people adults support, such as children over age 17, elderly parents or

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adult children with a disability.

For itemizers, many previously itemized deductions are eliminated; others including home mortgage interest and state and local taxes are significantly reduced; but allowable charitable deductions are increased; student loan interest are still deductible.

Mortgage interest rules in 2017 allowed for deductions if \$1 million of primary, secondary and some home equity debt. The new rules for 2018 limit the deduction to \$ 750,000 of mortgage debt only for new loans. This provision would be applicable for taxable years beginning January 1, 2018 through December 31, 2025, when the limit would return to \$1 million. The new rules also eliminate deduction for interest on new home equity loans until taxable years beginning after December 31, 2025.

State and local tax deduction is now capped at \$10,000 for sales and state and local property taxes or sales and state and local income taxes in 2018.

The good news for itemizers, however, is the overall limit on itemized deductions is eliminated.

### 3. Healthcare Deductions

Medical expense deduction, particularly important for their impact on retirement plans, has changed for both 2017 and 2018. Taxpayers whose eligible medical expenses exceed 7.5 percent of Adjusted Gross Income (AGI) will be able to claim the deduction. Previously in 2017 the medical expense deduction was set at 10% of AGI. Important to note, the threshold reverts back to 10 percent in 2019.

The recent tax reform has also eliminated the individual mandate, which penalized people who did not have health insurance coverage.

### 4. Retirement Accounts, such as 401(k)s, IRAs, Roths Stay the Same

There are some minor changes that investors should be aware of. For instance,

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investors who converted funds from a traditional IRA to a Roth IRA can no longer undo or re-characterize the conversion once it's done. Investors may want to check with their tax professionals to see if any other changes affect them. Retirement accounts, however, remain attractive options for taxpayers looking to save and invest for their retirement.

For investors in 401(k) retirement plans, the tax benefits of tax-deferred retirement accounts and contribution limits remain the same despite worries they would be curtailed. Changes were small and affect only a certain subset of taxpayers and investors.

## **5. Big Tax Breaks for Business Owners Who Qualify for Pass-Through income**

One of the most significant tax change for individuals is the modification in the treatment of income from pass-through entities. Many businesses are pass-through entities and the effect of these changes could be greatly beneficial.

Business structures such as partnerships, S corporations and sole proprietorships generate pass-through income through their business income.

The new tax rates have a significant effect on pass-through income. In 2017, pass through income (income currently taxed to the end taxpayer, not the corporate level) had a maximum tax rate of 39.6%. The changes in 2018 if you are eligible for the pass-through deduction, allow for a 20% deduction to be taken off the table for tax calculation purposes. That being said, the new highest tax rate of 37% would reduce the effective tax rate to 29.6%. These changes are complex so it is important to consult your tax professional.

Business owners may want to consider converting from a C corporation structure to an S corporation or partnership to take advantage of the pass-through benefits. Also, retirement plan contributions may dilute the benefit of the pass-through income, so all must be considered when determining these benefits and how they can affect you.

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With the new rules in place temporarily for expensing capital equipment purchases, business owners may also want to review their capital expenditure plans.

## 6. Fewer People Will Have To Deal With The Alternative Minimum Tax (AMT)

The Alternative Minimum Tax (AMT) was designed to prevent high-income individuals from avoiding income tax by piling up deductions. It is essentially a parallel method for calculating your income tax liability. The tax reform makes changes designed to limit the impact of the tax. The complex alternative minimum tax remains, but has been restructured in a way that is likely to affect far fewer people by raising the minimum income level at which the AMT could apply from \$ 50,600 to \$ 70,300 for individuals and from \$ 78,750 to \$ 109,400 for married couples filing jointly.

## 7. Estate “Death Tax” and Gift Tax limits Rise

The threshold for estate taxes is raised from \$5.49 million to \$11.2 million. That’s good news. The new tax rules double the federal estate tax exclusion to \$11 million for individuals and \$22 million for couples. But that threshold is only in place until 2025. And bear in mind that, whatever the inheritance level heirs could be subject to income taxes due at the time.

Not many estates are this large, making this type of planning even more of a specialty for advisors.

Estate planning strategies should be reviewed and updated to take advantage of the much higher upward limit.

## 8. Charitable Giving

The increase in the standard deduction could have ramifications on charitable giving, which is an itemized deduction. Investors who take the standard deduction in 2018 may not get any tax benefit from charitable giving or they might get more.

Philanthropic investors who itemize might consider changes to their donations.

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As with many provisions for individuals, the limit on state and local tax deductibility expires in 2025.

## 9. Your Portfolio

An important indirect benefit are major corporate tax rate reductions. They are expected to support a continuing bull market, but portfolios should still be structured to anticipate future market declines.

## 10. 529 Education Savings Accounts More Flexible

529 plans were created in 2001 and since their inception could only be used for college expenses. Finally for the first time, these accounts can be used for primary and secondary education up to \$10,000 a year per student. This is a huge expansion of the appeal and utility of 529 plans.

Previously, investors looking for tax preference on education costs prior to college had to use other account types such as Coverdell Education Accounts. Coverdell accounts will remain available, despite speculation they would be curtailed. Those accounts have disadvantages compared to 529s, though, including much lower contribution limits.

Clients looking for ways to gain tax efficiency when paying for private school prior to college will find the 529 account now potentially even more compelling than it was before. Contribution limits remain the same, allowing for annual contributions in 2018 of \$15,000 for single taxpayers and \$30,000 for those married filing jointly.

Some taxpayers might consider making five years of contributions ahead of time, amounting to \$75,000 for individuals or \$150,000 for couples.

## 11. Beware of Life Events: Expected and Unexpected

### Divorce

- Alimony payments, which can be part of a divorce agreement and go to the ex-spouse who earns less money are no longer deductible for the

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person who writes the checks. This provision of the tax reform will apply to couples who sign divorce or separation paperwork after December 31, 2018.

## The Disaster Deduction

- Losses due to fire, storm, shipwreck or theft that are not covered by insurance used to be deductible, assuming they exceeded 10% of adjusted gross income (AGI). But now through 2025, people can only claim that deduction if they've been affected by an official national disaster.

## The Deduction For Moving Expenses

- The deduction for moving expenses for most people will no longer be available. For example, you no longer will be able to deduct the cost of their U-Haul when they move for work. There may be some exceptions for members of the military.

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## WHAT'S NOT CHANGING

Although a great deal of attention is being paid to the areas in the tax code that are changing, it is equally as important for investors to recognize that many aspects are staying the same.

### 1. Dividend and Capital Gains Tax Rates Remain Unchanged

Investors with taxable portfolios that generate dividends or where investment sales are being considered may still be affected by dividend and capital gains rates. Tax rates on dividends and long-term capital gains stay where they are in 2018. A minimum tax rate of 15% for taxpayers in the lower tax brackets for capital gains and qualified dividends. For those in the highest tax bracket, the tax rate is 23.8%, including the 3.8% Net Investment Income Tax, associated with the Patient Protection and Affordable Care Act (Obamacare).

Investors and advisors should continue to position investments strategically in



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accounts to take advantage of preferential tax treatment given to qualified dividends and long-term capital gains.

## 2. Tax-Lot Selling Rules Stay The Same

Tax-aware investors who have bought investments over time, may have unrealized gains and if you are considering selling, you should remain aware of tax-lot selling rules. The good news for investors is that they are still able to determine the most appropriate tax lot to use for cost-basis purposes on investment sales. This preserves an important planning tool for investors. In some versions of the tax bill, it was proposed that investors would need to use first-in first-out accounting, where investors would use the cost basis of the shares they bought first. That could have meant higher capital gains for many investors.

Moving forward, investors and advisors are still able to analyze investments bought over time and consider which lots are most appropriate to sell for tax purposes.

Investors can choose the specific lots to use for cost basis, or, in many cases with mutual fund shares, opt for the average cost of the shares bought over time. Proper tax planning alongside your financial and retirement planning is a must to avoid negative impacts on your cash flow both pre-retirement and most especially for retirees.

## 3. Municipal Bonds' Attractiveness Remains Unchanged.

Investors who look to municipal bonds as a source of tax-exempt income also have good news. The reduction of the top tax rate could reduce the appeal of municipal bonds for some taxpayers. But at the same time, munis get more interesting due to the loss of itemized deductions. The bottom line for municipal bond investors: munis remain an important options for tax-aware investors.

Demand for municipal bonds from banks and insurers may ease a little. But individuals seeking income may still find municipals to be a potential source of tax-advantaged income and diversification. For higher tax bracket investors in states like

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New York and California, the relative attractiveness of local bonds could actually improve.

For retirees, important to note that muni bonds and proper investment choices should go hand and hand with your tax planning. Remember Social Security and Medicare look back two years at your modified adjusted gross income (MAGI) to determine Medicare costs. Modified AGI includes tax exempt bond interest. Proper planning ahead of retirement can create significant savings to health care costs and more.

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