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Re: What Does the New Tax Law Mean for Me?

GENERATIONAL
WEALTH MANAGEMENT
A Registered Investment Advisor

Late last year, President Donald Trump promised to deliver a "big, beautiful Christmas present" to Americans that would revive an anemic U.S. economy.

While the holidays are past, the sound and fury continues as pundits on both sides of the political spectrum debate the long-range ramifications of the "Tax Cuts and Jobs Act," the first major revision of the tax code in 3 decades.[1]

Financial analysts are joining the chorus of speculators trying to determine how the legislation, signed into law December 22, will affect American taxpayers and investors.

In early November 2017, Trump told senior administrative officials that he preferred calling it "the Cut Cut Cut Act."[2] Most of the tax changes took effect New Year's Day; however, few of them are permanent.[3]

The Tax Basics

The most obvious and most publicized parts of the tax law are the cuts, most of which expire at the end of 2025: the individual tax reductions, the increased child tax credit, the doubling of the exemption for estate taxes, and a hike in the alternative minimum tax exemption.[4]

The reason for the expiration on the individual cuts was to ensure the legislation doesn't boost the deficit in 10 years, therefore allowing it a simple Senate majority vote.[5]

An increased tax deduction for medical expenses is retroactive to cover 2017 and 2018.[6] In 2019, the tax law rescinds the Affordable Care Act's (Obamacare) individual mandate requirement for health insurance and deductions for alimony payments for new divorces.

The Business Cut

American corporations will experience a tax rate drop from 35% to 21%. While critics of the tax plan said the corporate tax rate reduction wouldn't spur commercial growth, increasing numbers of industry leaders are saying the new rate is already generating growth in both domestic and international markets.[7]

Trump had initially sought a 20% corporate tax rate to make U.S. industries more competitive in the world market and to lure those with overseas offices back to the United States, but Congressional leaders chose 21% to improve the plan's revenue outlook.[8]

The difference between the two lies in the details. While the 14% corporate tax drop will significantly improve the United States' competitive advantage on the world stage, the additional percentage point (from Trump's 20%) provides the United States with a substantial economic edge.

The extra point may translate into a minute drop, if any, comparatively between the two early proposals in additional revenue going to the IRS; the tax act's expensing rules more than wipe away any distinction by providing incentives for new business investments.[9]

Previously, the United States had the 4th highest corporate tax rate in the world behind the United Arab Emirates, Comoros, and Puerto Rico.[10]

Despite the big tax advantages for corporations under the next tax act, businesses will only be able to deduct 30% of earnings before interest, taxes, depreciation, and amortization.[11] The old rules allowed businesses to deduct 100% of interest payments from taxable earnings.

That percentage deduction will exclude depreciation or amortization expenses in 2022. Also starting in 2022, companies won't be able to write off costs for research and development but will be required to distribute those expenses over five years, which experts say will generate nearly $120 billion in tax revenue in the next 10 years.

Companies will have to return their foreign earnings starting this year but will be able to pay those bills over 8 years. The law also prevents domestic businesses or foreign subsidiaries from reducing their U.S. tax bill by making cross-border payments to affiliates.[12]

The Tax Brackets

The tax law maintains the 7 tax brackets but lowers rates.[13] Employees can expect to see lower tax withholding in their February paychecks. The new rates return to the 2017 rates in 2026. Income levels in the brackets will rise slightly with inflation based on the consumer price index.

The law doubles the standard deduction from $6,350 to $12,000 for single filers and from $12,700 to $24,000 for married or joint filers. The deduction returns to 2017 rates in 2026. About 70% of Americans claim the standard deduction.[14]

The National Association of Home Builders objected to the deduction change because the act excluded the "homeownership" tax credit.[15] Under the act, fewer taxpayers will take the mortgage interest deduction with the higher standard deduction since only the first $750,000 in mortgage interest is deductible.

Some homebuilders argue that fewer taxpayers taking the mortgage deduction may deflate the real estate market.[16]

The act also reduces the number of deductions taxpayers can take, which includes moving expenses (except for the military service members). For divorces that commence after December 31, 2018, divorced taxpayers will no longer be able to deduct alimony payments; however, those receiving payments will no longer be required to claim the payments as income.[17]

Deductions for charity, retirement savings, and student loan investments remain the same as under earlier tax rules; with higher standard deductions, some fear charity giving could decline. The doubling of the standard deduction removes the monetary incentive for middle-class donors to give to charity, critics of the tax bill argue.[18]

The new tax law caps the deduction for state and local income taxes at $10,000.[19] The deduction was unlimited in 2017 and previous years. The cap applies to filers who itemize and includes total income, sales, and property taxes up to that limit.

Taxpayers may choose to deduct either income taxes or sales taxes. Tax analysts say deducting income taxes is better for taxpayers unless taxpayers live in states with no income taxes. Property taxes under the old system were deductible.[20]

Nearly 90% of the benefits for the new state and local deduction will go to the taxpayers with incomes higher than $100,000.[21] While less than a third of taxpayers itemize their deductions, most of those take the state and local deduction.

Under the old rules, high-income and high-tax states like California, New York, New Jersey, and Illinois benefited the most from the state and local tax deduction.[22]

While most taxpayers who itemized their taxes used the state and local tax deduction, fewer are expected to use it with the higher standardized deduction.

By the Numbers

The number of tax brackets remains the same at 7 but shifts income ranges into higher categories, meaning about 80% of taxpayers should reap some reduction in their tax bills.[23] Slightly less than 5% of taxpayers will see slight tax increases.[24] That number is expected to rise to 9% by 2025 and 53% by 2027.

The new law allows taxpayers with children to claim larger credits under the Child Tax Credit.[25] The per-child credit increases from $1,000 per child to $2,000; $1,400 of that amount is refundable for low-income families, a provision pushed by U.S. Senator Marco Rubio, R-Florida. The original Senate tax bill held the deduction at $1,000.

The law increases the income threshold for the child tax credit from $110,000 for families to $400,000.[26] Deductions for dependents 17 and older and the elderly is $500 per person.

For the Investors

The new tax law has little direct impact for investors. Provisions, which rescind the Affordable Care Act's individual mandate requirements to obtain health insurance, may have an impact on health insurers and providers.[27] While critics of the tax bill say fewer people will choose to get health insurance, proponents say the health care costs will go down in the long term in an open and more competitive market.

Real estate is expected to experience mixed results. Restrictions on state and local tax deductions may put a damper on housing demand in high-tax states like New York and California, critics argue. Restrictions on mortgage interest deductions may squash interest in second houses and vacation homes.

On the flip side is the way pass-through income is taxed.[28] For the sake of federal income taxes, sole proprietorships, partnerships, LLCs, and S corporations are considered pass-through businesses. They are not subject to income taxes since the business owners are taxed individually, which encompass their profits and losses.[29]

The tax law changes the way pass-through income is taxed. Business owners may qualify to take 20% deductions for business-related income.[30] The objective was to provide an incentive for job creation by corporations. The provision also benefits real estate investors.

The gas and oil industries are set to experience gains with the opportunity to write-off new equipment purchases. Miners will also be able to reap the benefits of the new equipment expense provision, which will allow them to modernize their businesses. The opening of the Arctic National Wildlife Refuge to drilling is expected to generate $1 billion in revenue for the government in the next 10 years.

The tax law indirectly benefits investors by allowing them to put more money into their savings.[31] Changes in the law, for example, help shield portions of income of property owners who make capital investments or property improvements.

Proponents say the corporate tax cuts will spur economic growth and thereby boost prospects for investors seeking a broader selection of market opportunities.

Holders of Roth IRA accounts are no longer able to do recharacterizations of their conversions.[32] A recharacterization allowed Roth IRA account holders to "undo" or "reverse" rollovers or conversions, according to the IRS.[33] Roth holders do this by instructing their financial institutions (which hold their accounts) to transfer their money from their Roth IRA to a traditional IRA prior to the tax-filing due dates.

The transfer enables the account holder to ignore Roth IRA contribution requirements. Account holders typically undo their conversions to a Roth IRA following a drop in the stock market. A market decline often translates into higher capital gains taxes.[34]

What Do I Do Now?

Take a look at your previous years' tax returns. Has your tax situation changed?[35] Do you expect your taxes to drop? If you expect the amount of taxes you pay or your ability to itemize to change, you may want to change future contributions (such as for charity) or deductions.

Retirees can benefit from the increase in the standard deductions for charity. Analysts suggest doubling donation amounts and giving less frequently to meet the new amounts. For individuals the new amount is $12,000; for married couples filing jointly and surviving spouses it's $24,000.[36] For example, give more in a single year and then skip the next year, which will enable high-income taxpayers to write-off the higher amount. Financial professionals also point to donor-advised funds rather than donating cash.[37]

Analysts also suggest retirees monitor their income (withdrawals from their retirement accounts, which are taxable) to avoid moving into a higher tax bracket. Retirees approaching 70½ this year should start taking early distributions if they have high balances in their retirement accounts to also avoid moving into a higher tax bracket.

We hope you found this report on the new tax law useful. We strive to keep you abreast of the most recent developments in the financial industry.

We certainly understand how tax management and financial planning can get complicated and confusing. Consulting with a tax professional can give you peace of mind and the assurance that your finances are in order.

If you have questions about the information in this report or would like to discuss your finances, contact us today. We would be delighted to speak with you.

Kind Regards,

The Team at GENERATIONAL WEALTH MANAGEMENT

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Information current as of January 17, 2018.

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Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.

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