QUARTER NOTES

First Quarter 2019

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Perception and reality

The first tax filing season following the Tax Cuts and Jobs Act (TCJA) of 2017 is about to begin. There has been much worry in some quarters about the likely effects of this tax reform legislation. Now we will move beyond perception into reality. For example, there was a perception that the TCJA would "lose" tax revenue. In reality, the IRS collected more revenue for the fiscal year that ended on September 30, 2018 than for the year-earlier period, some $14 billion more. (Federal spending increased by much more than $14 billion, so the national debt continued to grow.)

Here's a run-down of the key changes individuals will be working with this year.

- **Fewer itemized deductions.** Many expenses that were formerly deductible will no longer have that status. Moving expenses and tax preparation fees, for example, can no longer be written off. Deductions for charitable giving remain in place.
- **$10,000 SALT cap.** The $10,000 limit on the deduction for state and local taxes (SALT) has been contentious because its impact is expected to be much higher in the coastal states that have above-average tax burdens. However, the true impact of this cap is uncertain. Top earners are more likely to have large SALT burdens, but they are also more likely to be hit by the

Continued on next page

The reckoning

Everyone had an opinion on how the Tax Cuts and Jobs Act would affect them, for better or worse. Now we find out the final score, as we all complete our first tax filing following that tax reform. Our lead article touches on several key considerations.

On page 3 you'll find "New IRA Numbers for 2019." If you haven't yet made your IRA contributions for the 2018 tax year, it's time.

Please bring us your questions about saving and investing. Put our experience to work for you.

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Alternative Minimum Tax (AMT). Those who must pay the AMT get no SALT deduction at all.

• **Doubled standard deduction.** The loss of itemized deductions will be cushioned for many taxpayers by the rough doubling of the standard deduction, to $12,000 for singles, $24,000 for married filing jointly, and $18,000 for heads of households. Those who can use the standard deduction should enjoy a reduction in paperwork and simplified tax filing.

• **Reduced AMT impact.** The amount exempt from the Alternative Minimum Tax is substantially larger for 2018, which should excuse many taxpayers from having to concern themselves with this second tax calculation. For marrieds filing jointly, the exemption is lifted from $85,500 in 2017 to $109,400 in 2018. For single filers, the exemption goes from $54,300 to $70,300.

What's more, the AMT exemption "lasts longer" now. In 2017, that exemption phased out for marrieds filing jointly with alternative minimum taxable income (AMTI) over $160,900, and it was fully phased out at AMTI of $498,900. For 2018, the phaseout starts at $1 million of AMTI and isn't fully phased out until $1,437,600. For singles, the phaseout range starts at $500,000.

Kiddie taxes

TCJA made an important change to the calculation of the "kiddie tax," the special tax rules intended to prevent income shifting within families to create tax savings. The tax formerly was based upon the marginal tax rate of the child's parent. This was awkward, because the child had no legal right to learn what the parent's tax rate was, and if the parent filed for an extension of time, the rate might not even be knowable in a timely way. The remedy was to do away with reference to the parent's tax rate and use instead the tax rate schedule for trusts and estates.

The kiddie tax applies to "unearned" income of a child in excess of a threshold amount, $2,100 for 2018—if the threshold is not exceeded, no kiddie tax. Unearned income includes dividends, interest, and capital gains. The kiddie tax does not apply to one who files a joint income tax return, and it does not apply if both parents have died. There is also an age dimension to the application of this tax. Those affected are:

• any child 17 or younger at year-end;

• 18-year-olds whose earned income does not cover half of their support; and

• those age 19 to 23 who are full-time students (for at least five months of the year) and whose earned income does not cover half of their support.

The child does not have a personal exemption for calculating taxable income. The basic standard deduction for the child will be the greater of $1,050 or the sum of $350 plus earned income, up to a limit of $12,000.

Example. Betsy, age 17, has $2,500 of earned income from a part-time job and $7,500 of interest income. Therefore, her standard deduction is $2,850. Betsy's taxable income is $7,150 ($10,000 gross income minus the standard deduction). Because the standard deduction offsets all of the earned income and $350 of the unearned income, all of the taxable income is subject to the kiddie tax.

The first $2,100 of unearned income is taxable at ordinary income tax rates, that is, 10%. So that's $210. The next $2,550 is taxed at the lowest bracket for estates and gifts, also 10%. That comes to $255. The final $2,500 of income is taxed at 24%, or $600. Betsy's total tax liability comes to $1,065.

Without the kiddie tax, all of Betsy's income would have been taxed at 10%, a liability of $715. Thus, her kiddie tax is $350, a tax increase of nearly 50% compared to her ordinary obligation.

Start early

CPAs will be extra busy this year, so taxpayers should not procrastinate if they plan to seek professional tax filing help. Do-it-yourselfers also may want to allow for extra time for the tax filing chores, given the newness of the rules.

How do these tax changes factor into financial and investment planning? That's where we come in. We don't give tax advice, but we will be happy to be a sounding board for you to discuss your wealth management issues in 2019.

New IRA numbers for 2019

It's been six years since the limits on IRA contributions have gone up. Up they go for the 2019 tax year, lifted from $5,500 to $6,000. The additional $1,000 contribution allowed for those 50 and older is not inflation adjusted, so those folks have a limit of $7,000 in 2019.

What if you haven't made an IRA contribution yet for the 2018 tax year? It's not too late, you have until the tax-filing deadline to take that step toward retirement security.

Example. Angela is 46 years old. She can make a $5,500 IRA contribution for 2018, and then a $6,000 contribution for 2019 and following years. Once she hits 50, her limit will go to $7,000, even without future inflation adjustments. That means Angela has the opportunity to set aside $99,500 between now and age 60 for her retirement. If those savings were to earn 8% per year, she'd have $190,005 by then. Of course, there is no guarantee of a steady 8% return, this is for illustration only.

A contribution is one thing, the deduction is something else. Those who have no employer retirement coverage are permitted a full deduction for IRA contributions, regardless of income. Those who have such coverage will find the deduction phases out as their income grows, as shown in the table below.

A person whose spouse has an employer-provided retirement plan also has limits on the deduction.

The Roth IRA should also be considered, especially by those whose income exceeds the deductibility threshold. There is no deduction for the contribution, but there is the possibility of complete tax freedom for all distributions. What's more, the rules regarding required minimum distributions at age 70½ do not apply to Roth IRAs as yet. Income limits apply to Roth IRAs as well, but those limits are higher than for deductible IRAs.

Key IRA boundaries

		2018	2019
Contribution limit		$5,500	$6,000
Phase-out range for IRA deduction for those covered by employer plan	Single	$63,000 - $73,000	$64,000 - $74,000
	Married filing joint	$101,000 - $121,000	$103,000 - $123,000
	Married filing separately	$0 - $10,000	$0 - $10,000
Phase-out range if only spouse has employer coverage	Married filing joint	$189,000 - $199,000	$193,000 - $203,000
	Married filing separately	$0 - $10,000	$0 - $10,000
Phase-out range for allowable Roth IRA contributions	Single	$120,000 - $135,000	$122,000 - $137,000
	Married filing joint	$189,000 - $199,000	$193,000 - $203,000
	Married filing separately	$0 - $10,000	$0 - $10,000

Source: Internal Revenue Code; M.A. Co.

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Just Ask Us

What happened to the stock market in December? Should I be worried about 2019?

Volatility returned to stock prices with a vengeance as the year came to a close. Uncertainty about the effect of tariffs, politics, and concern over interest rates seemed to be important drivers.

2018 was a very good year for the U.S. economy. Final figures are not yet in, but the Gross Domestic Product may have grown by more than 3% for the first time in over a decade. Corporate earnings surged by 20%, fueled by the corporate tax reform provisions of the Tax Cuts and Jobs Act. These factors drove the stock indices to new records during 2018, but they fell back to remain essentially flat by year-end.

Few predict a recession beginning in 2019, because labor markets are strong and economic fundamentals look good. On the other hand, growth may be slowing, and this bull market has been running for a long time. Caution is in order.

As 2018 began, price/earning ratios were high by historic standards, meaning that stocks were expensive. After the good earnings reports, the stock price declines toward the end of the year brought valuations closer to long-term average levels. That gives investors a better entry point into the market.

That last paragraph is what is known as "making lemonade from lemons." See your advisor to learn more.