SHARPER GRANITE LLC

Letter on the Economy

New Tax Law: What Our Clients Need to Know

The year began with news of the most sweeping Federal tax changes in three decades and left many wondering how their tax strategy may change in 2018. Granted these changes will not affect our tax bill until April 2019, but it is important to understand the new tax rules as investors.

The tax code is complicated, and the rules can be confusing. For these reasons it is always a good idea to consult with a tax professional for your specific situation. Below, we highlight some of the biggest changes affecting investors in 2018 and share insight as to how these changes may indirectly impact other elements of the economy.

Income Tax

Although the new law keeps seven income tax brackets, it lowers the rates and shifts income into lower brackets. See chart at right for how income distribution changed across the new brackets.[1] This change alone would lower Federal income taxes for everyone; however, several other changes increase the final calculation for many.

Capital Gains Tax

The long-term capital gains and qualified-dividend tax rates remain unchanged.[2] Rates of 0%, 15% or 20% will be applied to gains on assets held for a year or more based on income level. Short-term capital gains will be taxed at the <u>new</u> ordinary income tax rates. Given that income taxes are decreasing while capital gains taxes are unchanged, *the relative importance of managing capital gains taxes has increased.* Your advisor's ability to manage capital gains taxes is as important as ever.

Ordinary Income Tax Brackets
Married, Filing Jointly

Income Level	Tax Rate 2017	Income Level	Tax Rate 2018
$470,700	39.6%	$600,001	37%
$416,701	35%	$400,001	35%
$233,251	33%	$315,001	32%
$153,101	28%	$165,001	24%
$75,901	25%	$77,401	22%
$18,651	15%	$19,051	12%
$1	10%	$1	10%

Taxable Income

529 Plans and UTMA Accounts

The new law expands the use of 529 college savings plans by allowing families to spend up to $10,000 a year from 529 plans on K-12 private school tuition. Previously, tax-free distributions from these plans were limited to college expenses. Even though the new law allows 529 plans to be tapped sooner, it is important to gauge how an early distribution will affect college savings down the road. Also, pulling money sooner detracts from the value of contributing to a tax-protected account in the first place.

We often help our clients strategically invest for a child using a custodial account, Uniform Transfers to Minors Act (UTMA), along with their 529 plan. UTMA accounts may now have an even stronger role in a child's investment strategy. Significant tax relief on investment earnings was given to UTMA owners, especially those in the highest income tax brackets. More than ever though, UTMA accounts should be carefully managed to generate investment earnings within a target range each year. If this can be done skillfully over the life of the UTMA, tax savings can be significant for high-income households.

Estate Tax

The new law increases the estate tax exemption to $11.2 million per individual ($22.4 million per couple).[2] However, it will not necessarily change many estate plans, because this increase is only in place through 2025. After this time, the estate tax reverts to the 2017 level of $5.49 million per individual, adjusted for inflation.

Alternative Minimum Tax

The alternative minimum tax (AMT) was changed but not eliminated. The AMT is a parallel tax system that requires taxpayers to calculate their taxes twice – once using the general rules and again using the AMT rules. They are then required to pay the highest amount. The new law helps somewhat by increasing the exemption and the exemption phase-out amount which means fewer will pay AMT.[2] These changes should benefit many middle- and high-income households that were previously affected by this tax.

State and Local Tax

One of the largest categories of deductions was significantly capped in the new law – State and Local Taxes (SALT). SALT deductions were capped at $10,000 for state and local income taxes, property taxes and real estate taxes.[2] For high income earners and owners of expensive homes in high income tax states, such as California, New York and Oregon, this change is substantial.[3] However, it is important to keep in mind that for many high earners, AMT already disallowed some of these deductions. The new AMT exemption limits may mitigate the effect of the SALT deduction cap in the final tax calculation.

Troublesome to million-dollar-and-up home shoppers, are the limits placed on mortgage interest deductions. For homes purchased in 2018 or later, the mortgage interest deduction is limited to $750,000 of indebtedness. [4]

Also, the interest on home equity debt is no longer deductible. For indebtedness prior to this date, the interest deduction remains at $1.0 million for a first mortgage and another $100,000 for a home equity loan.[4] These changes to the SALT and mortgage deductions are in place only through 2025.

Indirect Effects on Real Estate and Charitable Organizations

The elimination of the SALT deduction and lower limit on mortgage interest deduction is especially painful to those in California and New York where state income taxes are high, average income is high, and home prices are expensive relative to the rest of the country. This combined effect should be a negative factor for home prices in those states.

The new tax bill also indirectly hits charitable organizations. The higher standard deduction and limitations of the Schedule A categories, mean that many will no longer be able to itemize on a Schedule A. Without itemizing, donors may not receive tax deductions for charitable contributions. As a result, charitable giving is expected to decrease by approximately 4.5%, or $13B overall.[5]

As 2018 unfolds, we recommend you work closely with your tax professional and investment advisor to make the necessary adjustments to your investing, withholding, home buying and gifting strategies. This will help avoid any surprises this time next year.

Notes and Acknowledgements:

1. 2017-2018 Tax Brackets, bankrate.com, January 12, 2018
2. A Guide to Tax Changes, Factcheck.org, December 20, 2017
3. Tax Policy Center Briefing Book, State and Local Taxes, March, 2018
4. IRS, News Release IR-2018-32, Feb. 21, 2018
5. "Charities Fear Tax Bill Could Turn Philanthropy into a Pursuit Only for the Rich", Washington Post, December 23, 2017