



## A Guide To The New Rules On Tax Deductions In 2018

**U**ncle Sam giveth, and Uncle Sam taketh away. The new federal tax code, which went into effect in 2018 and affects the return you'll file in spring 2019, lowers taxes by expanding some deductions, but restricts or outright eliminates others.

Deductions lower your taxable income so you pay less tax. Here's how deducting items from your income were expanded, restricted, or eliminated.



### EXPANDED DEDUCTIONS

**Standard deduction.** The standard deduction is the amount you can subtract from your taxable income if you don't itemize — that is, individually deduct items like mortgage interest, charitable donations, and car loans. Nearly doubling the standard deduction to \$24,000 for joint filers and \$12,000 for singles pushes it up from \$12,700 and \$6,350, respectively. Fewer than half of taxpayers who itemized their 2017 return are expected to itemize their 2018 return. If you file using the standard deduction, preparing your return will be much simpler. If the standard deduction is less than the total of your itemized deductions, you'll still want to file by itemizing, subject to the rules below.

**Medical expenses.** If you itemize deductions, medical expense deductions will be more generous. For tax years 2017 and 2018, medical outlays in excess of 7.5% of your adjusted gross income are deductible. Starting in 2019, the threshold rises to the previous level of 10%. Congress is widely expected to consider extending the 7.5% threshold or making it permanent.

### Alternative minimum tax.

This very unpopular parallel tax system has been reined in and will zap fewer Americans in 2018. The AMT started in 1982 as an effort to reduce loopholes open to ultra-high-income earners, but its net gradually spread and it affected more individuals. In the 1990s, Congress hiked the AMT tax rate, stiffening its cost. Under the AMT, the standard

deduction and deductions for state and local income taxes are lost. With the new law, your exemption — the amount you can subtract from your AMT liability — is much larger. Previously, \$54,300 was exempt for a single-filer and \$84,500 for a married couple filing jointly. Respectively, the exemptions increased by almost a third, to \$70,300 and \$109,400.

**Child tax credit.** This actually is not a deduction against your income. It's a credit on your tax bill. A credit reduces your tax bill dollar for dollar. The credit for children under age 17 was raised to \$2,000 from \$1,000.

### RESTRICTED DEDUCTIONS

**State and local taxes.** Lawmakers

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## Volatility Returns

**T**he first quarter of 2018 proved to be a wake-up call for the complacent. Markets began the year on a tear; at one point in January, U.S. stocks were up 8%. Then came February, which ushered in a 10% drop. Stocks rebounded through the first half of March, only to drop again by month-end. By the time markets closed on March 29, U.S. stocks had swung to a loss of nearly 1% for the quarter. Developed international stocks fared slightly worse with a loss of 1%. Markets were set on edge by inflation worries, trade war fears and a string of negative tech company announcements, capped by a data privacy scandal at Facebook.

Despite the drama in financial markets, the global economic and corporate earnings backdrop still appears solid—and supportive of risk assets—for the near term. That said, we do believe we are in the late stages of the current economic cycle.

Over the shorter term, markets are driven by innumerable and often random factors that are impossible to consistently predict (although that doesn't stop lots of people from trying). Simply put: markets and economies are unpredictable. But, when it comes to the investment world, we are often our own worst enemy. We fall prey to performance-chasing, our natural inclination to "do something," and other behaviors that may have helped our ancestors but hurt us as investors. The best defense is a sound, fundamentally grounded investment process that you can have confidence in and be able to stick with for the long term.

As always, we appreciate your trust in us and welcome questions.

# Inflation: A Portfolio Risk That Never Dies

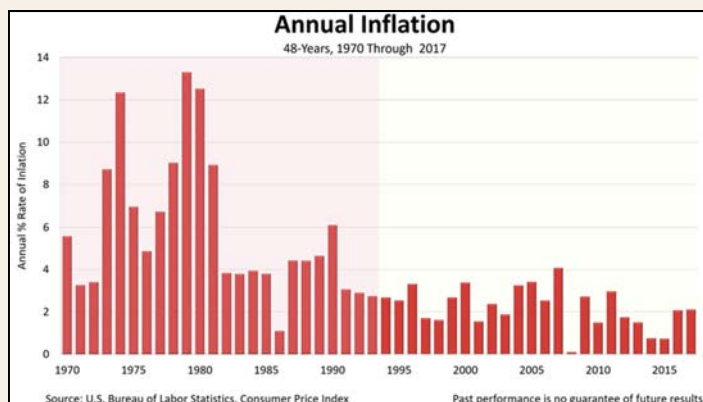
The threat of inflation is nothing like the double-digit affair of the 1970s, but it's still there. Dormant for years, inflation may seem irrelevant, but it remains a risk. Here's a short lesson for managing this risk.

In the 48 years after it raged in 1970, inflation was a tale of two times, distinctly different but equal in length. The first 24 years was a high-inflation period and low inflation marked the last 24 years.

The median Consumer Price Index, a widely-watched inflation barometer, was 3.8% for the 48-year span. However, the CPI topped 3.8% just once in the past 24 years, while hitting 3.8% or higher in 18 of the previous 24 years.

The table below shows the average yearly returns for seven distinct types of investments over the two 24-year periods. Some important observations:

- Large U.S. stocks' nominal return in the low-inflation era was 13.08% and, after subtracting the small CPI increase, 10.8%. In the high-inflation years, a 10.8% nominal return shrunk to 4.7% after inflation. High CPI slashed real returns after



inflation in half, a frightening risk to a retiree on fixed income.

- Stocks held up well in low-inflation times, because bonds — their chief competitor for investor capital — were yielding less income. Stocks performed okay in high-inflation periods, too. An escalating CPI eroded the value of bonds' interest income. Longer-maturity

inflation era.

- A real wild card for investors in securities over the last 48 years was commodities. Oil companies dominate commodities in this class of securities, but it also reflects prices of gold, food and raw materials. Historically, prosperity increased demand for goods and boosted commodities prices. Low inflation meant the opposite happened.

- It's easy to think commodities are irrelevant, but long-term financial history indicates otherwise. The fact that they were losers after years of good stock returns demonstrate why they remain important in a diversified portfolio. If you did not have some investments underperforming, you're not properly diversified. ●

		Large US Stock	Small US Stock	Non-US Stock	US Bonds	US Cash	Real Estate	Commodities
Low Inflation Years 24 Years with Below-Median CPI	Average Nominal Return	13.08	13.76	10.91	6.39	2.45	12.58	(1.97)
	Average Real Return	10.80	11.44	8.67	4.27	0.41	10.30	(4.03)
High Inflation Years 24 Years with Above-Median CPI	Average Nominal Return	10.82	12.61	11.33	9.03	7.39	14.26	21.98
	Average Real Return	4.70	6.26	5.21	3.00	1.33	7.86	15.13

Source: US Bureau of Labor Statistics, Consumer Price Index; Standard & Poor's Corp.  
Past performance is not a guarantee of your future results.

## New Deduction Rules For Business Owners

If you are a small business owner, Washington, D.C. has changed tax rules to lower your burden but the new rules are fairly complex. Many small businesses, and some that aren't so small, are "pass-through companies," tax-jargon that means the entity's net income isn't taxed at the corporate level but flows straight to their owners' personal returns. That income is taxed at personal income tax rates, as opposed to corporate rates that are generally lower.

The new tax law, though, has a valuable deduction that evens things out for pass-throughs, although the accounting gymnastics make this anything other than simple. "The size of

the deduction varies, depending on the nature of the business activity and the total income of its owner," says Howard Gleckman, a senior fellow at the Tax Policy Center. "It may also depend on how much the business pays its employees and how much property it owns."

Under the new tax law, the top personal rate drops to 37% from 39.6%, with similar reductions in brackets below the highest level. Yet most U.S. businesses are classified as C corporations, which means these companies are taxed separately from their owners. The new tax law lowers the federal tax for C corps to 21%

from 35%.

To balance out the difference, Congress allowed pass-throughs — limited liability companies (LLCs), S corps, partnerships and the like — a 20% deduction on their net income. The effect, for those in the top tax bracket, is to lower an owner's rate to 29.6% from 37%. True, 29.6% is higher than 21%, but owners of C corps, meaning shareholders, pay a tax on dividends they receive, usually 15%. So that comes closer to parity with the pass-throughs.

To prevent those part-time jobs into pass-through entities, lawmakers limited the new rules. So, you can't suddenly

# 2018 Estate Tax Changes And What May Be Ahead

**T**he tax code overhaul brought a lot of changes, but for the estate tax, the most far-reaching result was what didn't happen. Chiefly, you didn't lose the capital gains break on inherited assets when they are sold.

For tax purposes, the value of an asset, when sold, rises to its current market-value even though it was originally purchased at a lower price. The result is a lighter tax when an heir sells off stocks or other holdings that were part of the bequest.

For a narrow slice of the population, one weighty thing did happen with tax reform: Very wealthy households received a better deal on how much of their estate is taxable.

Their fondest wish did not come true, to be sure, and the new tax law did not kill what is derisively called "the death tax." However, Uncle Sam's claim on inherited mega-money has been shrunk by the new law. Starting in 2018, the exemption for estate tax nearly doubles. The

amount that can be passed along to heirs tax-free rises in 2018 to \$11.2 million from \$5.5 million for individuals, and to \$22.4 million, from \$11 million, for couples.

Above the new thresholds, the Internal Revenue Service expects to collect 40%. However, an important and favorable new wrinkle increases the exclusion annually by the rate of inflation.

The good news — and bad — is that through the end of 2025 is a great time to die, but Congress could modify the just-enacted rules as soon as 2019, particularly with recent changes in the political climate. Left unchanged, this new part of the tax code is set to

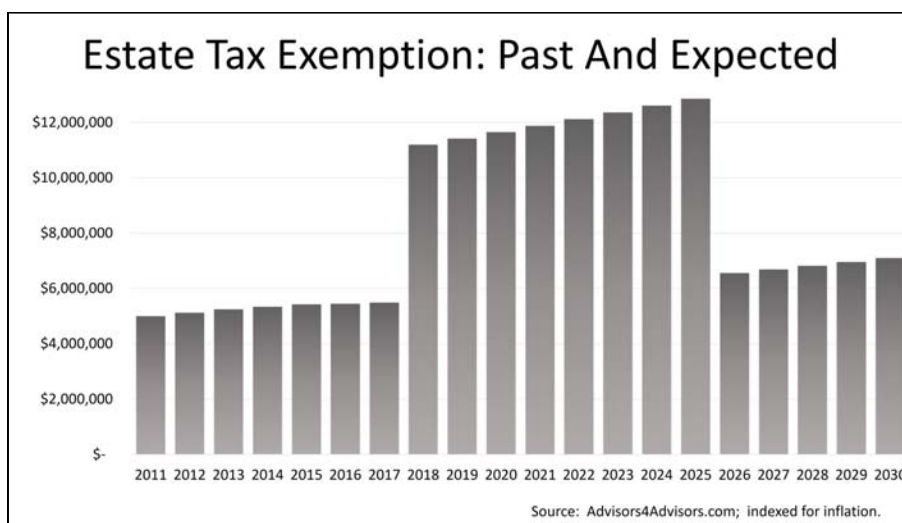
expire in 2026.

The number of estates that will pay any tax, according to the Tax Policy Center, is expected to drop from 5,300 in 2017 to 1,700 in 2018.

For heirs, the most important developments are what the House and Senate left alone. Those relate to capital gains and how surviving spouses can structure their own estates, a concept called portability:

**Capital gains.** The technical term for this untouched provision is a "step-up in basis." Let's say your father dies and you inherit Apple stock that he bought at \$8 per share in 1983, a little after it went public. Today, Apple stock changes hands for around

\$172. That kind of appreciation usually means a whopping capital gains bill, should you unload the shares to fund, say, buying a new home. In other words, a 15% tax bite on the price escalation of \$164 for each of the shares. Thanks to the step-up, the IRS values your Apple shares at \$172, rather than the earlier \$8 per share.



claim you are a consultant and create a sole proprietorship with the intent of grabbing a tax break.

Owners of service businesses — doctors, lawyers, and consultants — are limited in what they can deduct. Service businesses, according to the tax law, may count as their principal asset the "reputation or skill" of the owners and employees, while manufacturers may not.

In addition, Congress inserted income limits on the deductions that affect all pass-throughs, whether or not they're a service business. The 20% deduction is confined to income of \$157,500 for single-filers and \$315,000 for married couples. For service businesses, the deduction is phased out

progressively in excess of those levels and eliminated entirely when total taxable income is \$207,500 for singles or \$415,000 for couples filing jointly.

For other types of businesses, the deductions over those thresholds are limited to the greater of 50% of paid wages or 25% of wages plus 2.5% of the business' tangible depreciable property.

The pass-through rules are a big boon for real estate operators, whose properties usually each are LLCs. Further, if every property in a real estate owner's portfolio, say an office building or a shopping mall, is worth a large amount, the deductions can be sizable. For example, on a shopping mall worth \$5 million, 2.5% of its value is \$125,000. That's quite a deduction. ●

**Portability.** This is a helpful tax benefit for married couples, which Congress also let stand as is. It permits a surviving spouse to receive the unused part of the estate-tax exemption of the dead spouse. Example: Dick and Jane have an estate worth millions. Dick dies and leaves \$3 million of it to his children. Remember that the exemption for one person is \$11.2 million. Under the law, Jane can use the leftover \$8.2 million for her estate planning. That's a big deal to her beneficiaries.

It's important to take into consideration your resident state estate tax rules. Many states have lower exemptions and/or do not allow portability, which can materially impact planning for married couples. ●

# Understanding Economic Fundamentals

**A**t 105-months-old, this is the second-longest economic cycle in post-World War II America. For the last couple of years, a new phase of the expansion marked by rising interest rates began. Shifting fundamentals underpinning the economy can cause jitters in investment markets or spark changes in sentiment. In fact, the most recent correction — a loss of about 12% — was caused by fears of rising interest rates and inflation. So, let's set the record straight.

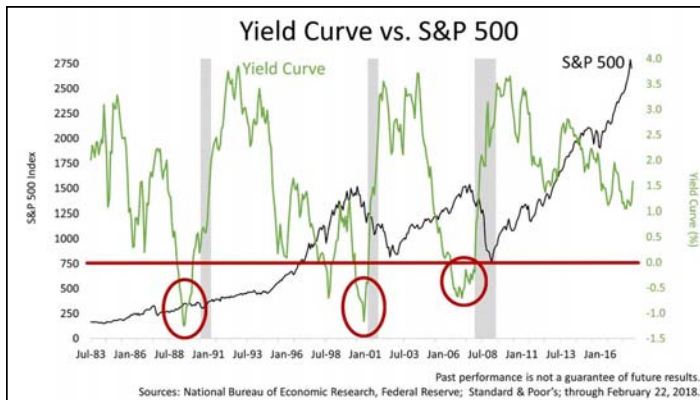
While no one can predict the stock market's near-term ups and downs, what we do know is that history shows rising rates are not bad for stocks. Actually, rising bond yields have often coincided with bull markets in stocks. The red arrows point to five periods since the 1990s when the yield on the 10-year U.S. Treasury bond rose sharply and stock prices rose at the same time.

A more reliable economic and financial indicator is the yield curve — the difference between



long-term bond yields and short-term interest rates. When the difference between the yield on 10-year U.S. Treasury Bond and the 30-Day U.S.

curve isn't near inversion. It's not signaling an end to the eight-and-a-half-year expansion and bull market. This 105-month old economic expansion is



approaching the length of the longest expansion, the 120-month cycle in the 1990s, and it's still got legs. Of course, indicators are not a guarantee and must be considered in the context of history and your personal situation. But the yield curve is key to watch as this expansion nears the 120-month longest-ever cycle in the 1990s. ●

## Tax Deductions In 2018

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placed a \$10,000 cap per return on deductions for state and local taxes (SALT). Till now, the amount you could deduct for SALT levies was unlimited. If you live in a place with high state and local taxes and home prices, you're hit hard. If you earn more than \$1,000,000 in adjusted gross income and live in California, Connecticut, Maryland, New Jersey, New York or Oregon, you're likely to see a material hike in your annual federal tax liability for at least the next decade.

**Mortgage interest.** You can continue to deduct this interest for first and second homes. The change: For mortgages dated after Dec. 14, 2017, only the interest on the first \$750,000 of debt is deductible. Before that date, the

\$1 million ceiling still applies. In places where home prices and, thus, mortgages, are low, that is not as much of a concern. In high-price locales, it is.

**Home equity interest.** You no longer can deduct interest paid on home equity loans, unless it is used to improve the dwelling. Many people use such loans, which are secured by their homes, to pay for college tuition or new cars. If a home equity loan and the mortgage totals more than \$750,000, the amount over that limit can't be deducted.

### ELIMINATED DEDUCTIONS

**Personal exemption.** Exemptions, which lowered your income by \$4,050 per person — usually family members — are gone. For some families with children over 17, who can't take advantage of the expanded tax credit, the elimination of the personal exemption will be a net loss.

**Alimony.** For divorce and separation

agreements made after 2018, alimony payments will no longer be deductible. The deduction is helpful to a paying spouse who is short on funds.

**Casualty and theft losses.** If your house burned down or a crook took your wallet, you could deduct the loss not covered by insurance to the extent it exceeded 10% of your income. Under the new law, only casualty losses suffered in a natural disaster declared by the president are deductible.

**Job expenses.** Continuing education, medical tests and licensing fees previously were write-offs. Not anymore.

**Moving expenses.** Before, you could deduct these if you moved to start a new job and it was a good distance (that varies by circumstances, but typically meant 50 miles away) from your old home. Now, that is gone, unless you are in the military. ●