

The COMPASS Chronicle

Spring 2018

Highlighting important wealth management issues

A Guide To The New Rules On Tax Deductions In 2018

Uncle 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.

Tax Planning 2018



Here's a guide to how the new rules expand some deductions, but restrict or eliminate others.

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 placed a \$10,000 cap per return on deductions for state and local taxes (SALT). Till now, the amount you could

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COMPASS Corner

Louis E. Conrad II, CFA®



Though volatility was nearly absent last year, it returned with a vengeance during the first quarter of 2018. U.S. stocks

were strong into late January, when the market experienced a correction, defined as more than a 10% decline from its peak. This was the first down quarter for U.S. stocks in over two years.

The market reacted negatively to concerns over trade protectionism, an acceleration of inflation, and technology stock weakness. By quarter's end, the Russell 3000 Index, a broad measure of the U.S. stock market, had lost 0.6% of its value, despite experiencing a correction intraquarter. International stocks fared slightly worse, declining 1.5% for the quarter.

Often when stocks decline, bonds strengthen, helping to offset the drawdown in stocks. Yet, in the first quarter, the U.S. bond market actually declined more than the U.S. stock market, with the Bloomberg Barclays U.S. Aggregate Bond Index falling 1.5%.

COMPASS' inclusion of short-term bonds and floating rate debt in client portfolios helped cushion the decline that was experienced by the broad bond market as interest rates increased. The yield on the 10-Year U.S. Treasury rose to 2.74% by quarter's end after beginning the quarter at 2.41%.

We believe the long-awaited stock market pullback has run its course. The fundamentals underpinning the economy remain positive, which provide a constructive background to support a further stock market advance.

Bitcoin, Chasing Your Tail, And Investing

Thinking about Bitcoin? Could be a good time to hop on, right?

Wrong! Usually, by the time the average investor jumps on a gaudy, freewheeling bandwagon, it's too late. The price spike has already occurred. If the investment is a fad, a sickening plummet may well await you.

Bitcoin blasted to a record high at rocket speed, hitting \$19,783 on December 17, 2017, before plunging 25% in the next 10 days. The crypto-currency may yet be destined for greatness over the long-term, but its supersonic ascent and subsequent nosedive look much like other notorious investment fads.

In 1637, Dutch investors lost their bloomers on tulip bulbs. During tulip-mania, prices for bulbs reportedly rose from November 1636 to February 1637 by 2000%, according to academic research published on Wikipedia.

These objects of desire were flowers. It made no sense. The crash of the bulbs shattered lives

and has ever since served as a beacon in financial history, warning investors of the risk in chasing performance.

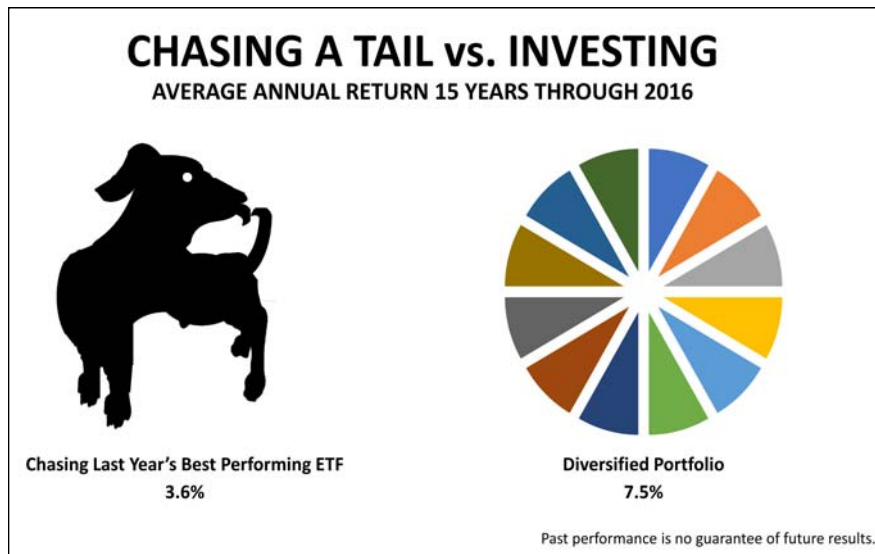
Investing in Bitcoin makes little sense considering that it is one of many crypto-currencies being mined on the Internet. The value of a crypto currency is set by supply and demand and supply is set by a software program that's not tied to a sovereign state. Transactions are easily hidden from tax authorities. Ultimately, crypto-currencies compete with sovereign nations, which is why some governments are starting to move to regulate them. In the time this was written, not only had the price of Bitcoin plunged 25%, but South Korea became

the first nation to ban all anonymous crypto currencies and regulate the rest.

Bitcoin's ascent was easy to spot as a mania, but the modern-day danger inherent in chasing hot performing investments is often far less apparent. For example, say you bought the No. 1 performing Exchange Traded Fund annually for 15 years through 2016. Sound like it could be a strategy for success? Think again, according to Dr. Craig Israelsen, Ph.D., who teaches portfolio design techniques to financial professionals. Your average annual return was 3.6% — less than half the annual return of a broadly diversified portfolio invested across 12 different

types of assets equally and rebalanced systematically every year over the same 15-year period through 2016.

Human nature makes people susceptible to investment manias, shiny bright objects like Bitcoin, and chasing last-year's winners. It's why people will always need investment professionals to stay focused on economic fundamentals, quantitative analysis, controlling fear and greed. ●



Giving More To Loved Ones – Tax-Free

While it may be better to give than to receive, as the adage contends, both givers and receivers should be happy with the new tax law. The annual amount you can give someone tax-free has been raised to \$15,000, from \$14,000 in 2017.

Exempting \$15,000 annually from gift tax, over time, transfers a lot of wealth to those you care about during your lifetime, while avoiding the tender mercies of the tax man, and married couples can have double the fun.

Take the example of a husband and wife with three married children and

six grandchildren. The husband can give \$15,000 each to his married children and the same amount to their spouses, and also \$15,000 to the half-dozen grandchildren — totaling \$180,000 — and his wife can do the same for the same 12 beneficiaries. The grand total is \$360,000 per year. No federal tax will be levied on these transfers of your wealth to family as well as friends.

In addition, you can give more than the annual exemption caps for college savings. The Tax Cuts and Jobs Act (TCJA) permits bunching five years of \$15,000 annual gifts into one year, by plugging it into a 529

college savings plan for a child or grandchild. That's \$75,000 in total. Assets in 529 savings plans grow tax-free, if used to pay qualified education expenses.

Gifts made during your lifetime reduce your exemption from tax on your estate. The TCJA more than doubled the estate tax exemption in 2018 from \$5.5 million to \$11.2 million for individuals, and from \$11 million to \$22.4 million for couples. All of these new levels will increase with inflation, though the formula annually adjusting inflation is less generous than before.

Lifetime gifts can be made directly

2018 Estate Tax Changes And What May Be Ahead

The 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.

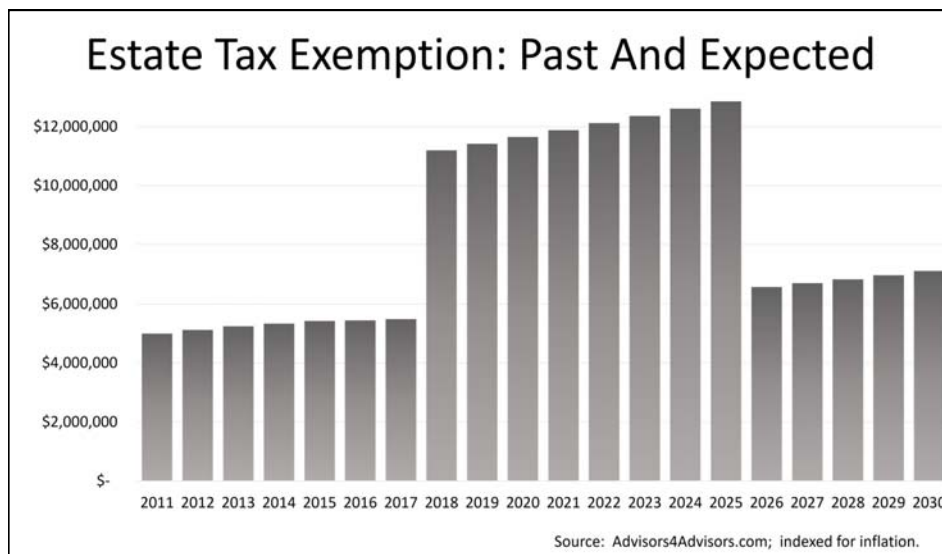
Capital gains. The technical term for this untouched provision is a "step-up in basis." Let's say your father dies and you inherit Apple stock that he bought at \$8 per share in 1983,

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.

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.

Please let us know if you have any questions regarding the recent changes in estate tax law. ●



or through trusts. With a trust, you place the gift of cash, securities, or other assets in an entity set up to make transfer of wealth after you die. The

assets in the trust avoid probate court, and makes the transfer faster, less costly, less likely to be contested, and generally more sure-footed. Trusts can influence the values of your

progeny by requiring the money you leave to be spent for religious, philosophical, or any variety of educational activities.



A trust also shields assets left to your heirs from lawsuits and business creditors. Should your grandchild get divorced, the trust money is shielded.

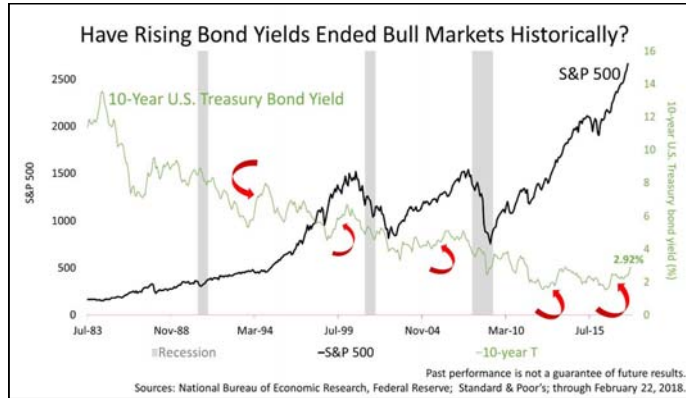
The friendlier tax treatment of transfers under the TCJA affects your estate plan and how your assets will be spent after you are gone, but it also may change your plan for gifting during

your lifetime. Giving assets during your lifetime can be satisfying because you can witness your impact and influence on the future of your family. ●

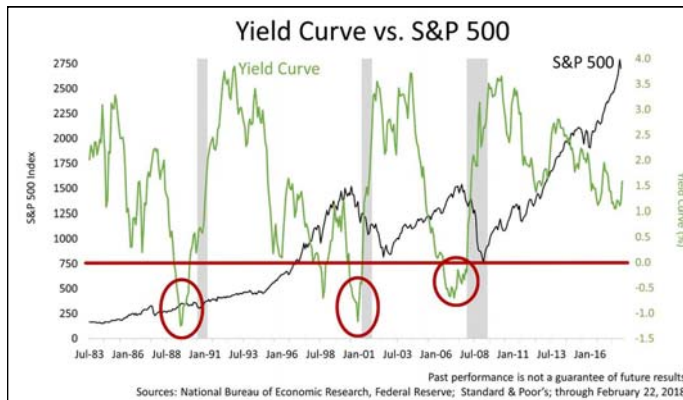
Understanding Economic Fundamentals

At 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. Treasury Bill is more than zero, an expansion could continue just fine. However, when the yield curve is inverted — when a 30-Day Treasury yields more than a 10-year Treasury — that has been bad for the economy and stocks. Before each of the last three recessions, the yield curve went into negative territory.

Currently, the yield 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. COMPASS believes the current expansion may have another 24 or more months left to run. ●

Tax Deductions In 2018

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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 \$100,000 in adjusted gross income and live in California, Connecticut, Maryland, New Jersey, New York or Oregon, you're very 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 a mortgage total 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 ex-

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.

Tax prep. Depending on the complexity of the return, these fees can amount to more than \$500. Uncle Sam no longer will let you deduct them, though. ●