It's Here!
The Tax Bill is Final!

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January 2, 2018

Well, after a lot of talk, a lot of smoke, we have some fire. Here is our quick overview on the new tax law. We will be providing a series of guides to the new law in more detail, but we thought you might be interested in a summary and our quick opinion.

1. It's big.

Yes, it is a big tax cut. By % of GDP, it not the biggest cut. Using that measurement, the 2010 'fiscal cliff' was bigger, the 1981 Reagan ERTA was bigger and the 2012 compromise to make the Bush tax cuts permanent was bigger. But make no bones about it, this was a very large and sweeping cut.

Opinion: The previous big cuts (1981, 2001, 2010, and 1977) were in economic downturns. Despite rhetoric to the contrary, we are not in an economic downturn. We wonder what effects a large cut will make in a reasonably healthy economy.

SIMPLE VERSION: It's big.

2. It's a cut for most people.

Yes, it is. The bracket rates for individuals go down, the standard deduction goes up, and there are some compromises. After all the haggling, many of the prior losers, like graduate students, medical expenses, and employee education, came out unscathed.

Opinion: Figure this out: if you cut taxes (which for a government is revenue), you either have to cut expenses or have a deficit. This new law will either cause a deficit, or (hopefully) create enough growth to increase revenue to pay for itself. The funny part is that it will be either touted as a huge tax cut, or reviled as a huge deficit increaser. Not surprising, both of those scenarios are likely wrong. It is about ½% of GDP by Treasury estimates, so neither huge in the cut nor huge in the deficit department.

SIMPLE VERSION: It's a cut. People who don't pay a lot of taxes get a cut, people who pay a lot of taxes get a bigger cut.

3. It's a cut for corporations.

Yes, for most. The prior law was complex and had a wide variety of corporate deductions and credits. The maximum rate was 35%, and is now 21%. Sounds like a huge cut, right? But the S&P 500's effective tax rate is lower than 35%. In fact, the actual average corporate tax paid is well under 21% for many corporations. Many deductions and credits are eliminated, but the overall effect is a tax cut to corporations.

Opinion: This new rate makes America competitive with the rest of the world. Large corporations hire very smart CPAs and tax attorneys to help them legally shield taxes. If it's better to shift profits to Ireland, so be it. It's like Michigan retirees deciding to make Florida their homestead to save on Michigan income taxes. Making the US corporate rate lower makes US corporations more competitive. Allowing immediate expensing of business capital expenditures will encourage businesses, including more foreign companies, to invest in and do business in the US.

SIMPLE VERSION: Corporations get a cut, which makes the US more competitive.

4. Small Businesses make out.

Yes, by a lot. There are two general ways to set up a business, as a C-corporation (see above), and as a pass-through, like a sole proprietorship, Subchapter S corporation, or a partnership (including LLCs). There are lots of cool things for small businesses in the new tax law. The biggest is a new Code section, 199A, which allows a deduction of 20% of pass-through income. Making it simple (it is not simple, I assure you), say Louise and Tom own a cabinet business. They have it set up as a Subchapter S corporation. They have $150,000 of pass-through income from the business, and take salaries of $100,000. They would deduct $30,000 from their income as Qualified Business Income (QBI). This QBI deduction is a reduction of Taxable Income, and not Adjusted Gross Income. All businesses can now also write-off asset purchases (other than real estate) up to 100%. For smaller businesses with under $25 million of revenue, they can continue to write-off interest and continue to use the cash method of accounting, versus accrual.

Opinion: The rules are complex, to say the least. The pass-through provisions are an 'equalizer' to the corporate tax cuts. If the pass-through rules wouldn't have changed, C-corporations would have a tax advantage, but the gap now between C Corporations and pass-throughs is much tighter. The new law, in a very complicated way, sets up rules for pass-through businesses that allow the calculation of QBI. There are exceptions for service businesses, like law firms and CPAs. But there is an exception to the exception which we call the 'Poor Lawyer' clause, which lets anyone with less than $315,000 of income ($157,500 if you are single) to take the QBI deduction. Overall, this will be a big change for business owners, who now will want to rethink how they conduct business and how they pay themselves. Oh yeah, and at the last minute, they added an additional opportunity for ~~President Trump, Senator Corker~~ real estate investors to use the QBI.

SIMPLE VERSION: Small businesses now have some big opportunities and need to talk to someone.

5. It's a cut for the wealthy.

Yes, and for a lot of others. The estate tax exclusion doubles, which helps families with estates under $22 million (or $11 million if single), but preserves the estate taxes on big estates. The highest income tax rate is cut from 39.6% to 37%, but the lower rates are cut by an equivalent percentage. To be sure, the lowest income level (under $25,200) get the lowest cuts, followed by those between $307,900 and $732,800, with the average cut of about 4.8%.

Opinion: Many media pundits are stating that the upper income taxpayers get most of the cuts. In dollars this is true. According to the Tax Foundation (2015 numbers), 50% of Americans paid 97.2% of taxes (the upper 50%) and the remaining 50% paid 2.8% of the taxes. The top 1% of the taxpayers (1.3 million) earned 19% of AGI and paid 38% of all taxes, and more than the bottom 90%, (124.5 million).

So, in our opinion, the people who paid the most taxes got tax cuts. Remember that in the US nearly half of the individual taxpayers pay no tax.

SIMPLE VERSION: It's good to have rich parents.

6. People in Blue states get hurt.

This is a big issue for people who itemize deductions and live in states with higher property and state income taxes (like California, New York or New Jersey). The new law limits state and local tax deductions to $10,000. You can deduct the first $10,000 or less if you itemize. But that means you have to have total itemized deductions over $24,000 ($12,000 if single).

Opinion: Media folks don't always do tax returns, so they don't necessarily know about the Alternative Minimum Tax (AMT). If you made over a certain amount ($54,300 for single, phasing out to $120,700; and $84,500, phasing out to $160,900), you were subject to AMT, which eliminated your state and local income tax and property tax deduction. So, many upper-middle income taxpayers didn't get the state and local tax deduction anyway. In LA County, if you have a $1 million dollar home, your taxes are still under $10,000 ($7,930 by our calculations). To afford a home like that, you'd need about $189,337 of income, according to Ratehub. Under the old rules, you'd probably lose your property tax deductions. With the new law, you won't have AMT, so the complaint is likely less relevant. Last point: if you live in California, you LIVE IN CALIFORNIA. Go enjoy the beach!

SIMPLE VERSION: Don't get tax advice from journalists.

7. A bunch of other stuff.

There is a bunch of other things, including pass-through provisions for businesses, especially small businesses (like LLCs, Subchapter S corporations, and sole proprietors). US based companies with offshore earnings will now need to pay taxes on their foreign earnings. Saving plans formerly for college (§529 plans) are now extended to K-12 education.

SIMPLE VERSION: There is a bunch more stuff in the 1,000 page bill. That's what we get paid to do: figure it out.

8. It's Simpler.

Nope. Thanks Congress. Everyone needs planning and tax advice more than ever. I think they could call this "The Equal Employment Opportunity Act for Tax Attorneys and CPAs". There are massive changes, and a lot of complexity.

SIMPLE VERSION: It's not simpler.

Stay tuned for more on the new law. We'll be publishing a series of guides, and as always, we're available to sit down and have a conversation. It's not often that we get a nice market return coupled with a planning opportunity. 2018 may shape up to be an interesting year.

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