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Montlake Financial News

Mid-Year Planning: Tax Changes to Factor In

The Tax Cuts and Jobs Act, passed in December of last year, fundamentally changes the federal tax landscape for both individuals and businesses. Many of the provisions in the legislation are permanent, others (including most of the tax cuts that apply to individuals) expire at the end of 2025. Here are some of the significant changes you should factor in to any mid-year tax planning. You should also consider reviewing your situation with a tax professional.

New lower marginal income tax rates

In 2018, there remain seven marginal income tax brackets, but most of the rates have dropped from last year. The new rates are 10%, 12%, 22%, 24%, 32%, 35%, and 37%. Most, but not all, will benefit to some degree from the lower rates. For example, all other things being equal, those filing as single with taxable incomes between approximately $157,000 and $400,000 may actually end up paying tax at a higher top marginal rate than they would have last year. Consider how the new rates will affect you based on your filing status and estimated taxable income.

Higher standard deduction amounts

Standard deduction amounts are nearly double what they were last year, but personal exemptions (the amount, $4,050 in 2017, that you could deduct for yourself, and potentially your spouse and your dependents) are no longer available. Additional standard deduction amounts allowed for the elderly and the blind remain available for those who qualify. If you're single or married without children, the increase in the standard deduction more than makes up for the loss of personal exemption deductions. If you're a family of four or more, though, the math doesn't work out in your favor.

Itemized deductions — good and bad

The overall limit on itemized deductions that applied to higher-income taxpayers is repealed, the income threshold for deducting medical expenses is reduced for 2018, and the income limitations on charitable deductions are eased. That's the good news. The bad news is that the deduction for personal casualty and theft losses is eliminated, except for casualty losses suffered in a federal disaster area, and miscellaneous itemized deductions that would be subject to the 2% AGI threshold, including tax-preparation expenses and unreimbursed employee business expenses, are no longer deductible. Other deductions affected include:

- **State and local taxes** — Individuals are only able to claim an itemized deduction of up to $10,000 ($5,000 if married filing a separate return) for state and local property taxes and state and local income taxes (or sales taxes in lieu of income).
- **Home mortgage interest deduction** — Individuals can deduct mortgage interest on no more than $750,000 ($375,000 for married individuals filing separately) of qualifying mortgage debt. For mortgage debt incurred prior to December 16, 2017, the prior $1 million limit will continue to apply. No deduction is allowed for interest on home equity loans or lines of credit unless the debt is used to buy, build or substantially improve a principal residence or a second home.

Other important changes

- **Child tax credit** — The credit has been doubled to $2,000 per qualifying child, refundability has been expanded, and the credit will now be available to many who didn't qualify in the past based on income; there's also a new nonrefundable $500 credit for dependents who aren't qualified children for purposes of the credit.
- **Alternative minimum tax (AMT)** — The Tax Cuts and Jobs Act significantly narrowed the reach of the AMT by increasing AMT exemption amounts and dramatically increasing the income threshold at which the exemptions begin to phase out.
- **Roth conversion recharacterizations** — In a permanent change that starts this year, Roth conversions can't be "undone" by recharacterizing the conversion as a traditional IRA contribution by the return due date.

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College Saving: How Does a 529 Plan Compare to a Roth IRA?

529 plan assets surpass $300 billion mark

As of September 2017, assets in 529 plans totaled $306 billion.

Source: Strategic Insight, 529 College Savings & ABLE, 3Q 2017 529 Data Highlights

Note

Investors should carefully consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. Specific information is available in each plan's official statement. Keep in mind that there is the risk that 529 plan investments may not perform well enough to cover costs as anticipated. Also consider whether your state offers any 529 plan state tax benefits and whether they are contingent on joining your own state's 529 plan. Other state benefits may include financial aid, scholarship funds, and protection from creditors.

529 plans were created 22 years ago, in 1996, to give people a tax-advantaged way to save for college. Roth IRAs were created a year later, in 1997, to give people a tax-advantaged way to save for retirement. But a funny thing happened along the way — some parents adapted the Roth IRA as a college savings tool.

Tax benefits and use of funds

Roth IRAs and 529 plans have a similar tax modus operandi. Both are funded with after-tax dollars, contributions accumulate tax deferred, and qualified distributions are tax-free. But in order for a 529 plan distribution to be tax-free, the funds *must* be used for college or K-12 education expenses. By contrast, a qualified Roth distribution can be used for anything — retirement, college, travel, home remodeling, and so on.

In order for a distribution from a Roth IRA to be tax-free (i.e., a qualified distribution), a five-year holding period must be met *and* one of the following must be satisfied: The distribution must be made (1) after age 59½, (2) due to a qualifying disability, (3) to pay certain first-time homebuyer expenses, or (4) by your beneficiary after your death.

For purposes of this discussion, it's the first condition that matters: whether you will be 59½ or older when your child is in college. If the answer is yes (and you've met the five-year holding requirement), then your distribution will be qualified and you can use your Roth dollars to pay for college with no tax implications or penalties. If your child ends up getting a grant or scholarship, or if overall college costs are less than you expected, you can put those Roth dollars toward something else.

But what if you'll be younger than 59½ when your child is in college? Can you still use Roth dollars? You can, but your distribution will not be qualified. This means that the earnings portion of your distribution (but not the contributions portion) will be subject to income tax. (Note: Just because the earnings portion is subject to income tax, however, doesn't mean you'll necessarily have to pay it. Nonqualified distributions from a Roth IRA draw out contributions first and then earnings, so you could theoretically withdraw up to the amount of your contributions and not owe income tax.)

Also, if you use Roth dollars to pay for college, the 10% early withdrawal penalty that normally applies to distributions before age 59½ is waived. So the bottom line is, if you'll be younger than 59½ when your child is in college and you use Roth dollars to pay college expenses, you might owe income tax (on the earnings portion of the distribution), but you won't owe a penalty.

If 529 plan funds are used for any other purpose besides the beneficiary's qualified education expenses, the earnings portion of the distribution is subject to income tax *and* a 10% federal tax penalty.

Financial aid treatment

At college time, retirement assets aren't counted by the federal or college financial aid formulas. So Roth IRA balances will not affect financial aid in any way. (Note: Though the aid formulas don't ask for retirement plan *balances,* they typically do ask how much you *contributed* to your retirement accounts in the past year, and colleges may expect you to apply some of those funds to college.)

By contrast, 529 plans do count as an asset under both federal and college aid formulas. (Note: Only parent-owned 529 accounts count as an asset. Grandparent-owned 529 accounts do not, but withdrawals from these accounts are counted as student income.)

Investment choices

With a Roth IRA, your investment choices are virtually unlimited — you can hold mutual funds, individual stocks and bonds, exchange-traded funds, and REITs, to name a few.

With a 529 plan, you are limited to the investment options offered by the plan, which are typically a range of static and age-based mutual fund portfolios that vary in their level of risk. If you're unhappy with the market performance of the options you've chosen, under federal law you can change the investment options for your *existing* contributions only twice per calendar year (though you can generally change the investment options on your *future* contributions at any time).

Eligibility and contribution amounts

Unfortunately, not everyone is eligible to contribute to a Roth IRA. For example, your income must be below a certain threshold to make the maximum annual contribution of $5,500 (or $6,500 for individuals age 50 and older).

By contrast, anyone can contribute to a 529 plan; there are no restrictions based on income. Another significant advantage is that lifetime contribution limits are high, typically $300,000 and up. And 529 plan rules allow for large lump-sum, tax-free gifts if certain conditions are met — $75,000 for single filers and $150,000 for married joint filers in 2018, which is equal to five years' worth of the $15,000 annual gift tax exclusion.

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Investing to Save Time Boosts Happiness Returns

"Time famine" is the feeling of being overwhelmed by the demands of work and life. Also known as time scarcity and time stress, this pressure is a "critical factor" in the rising rates of obesity.

Source: "Buying Time Promotes Happiness," PNAS, July 24, 2017

The more money you make, the more valuable you perceive your time to be — and the more time-strapped you may feel, according to University of British Columbia psychology professor Elizabeth Dunn.[1] So wouldn't it stand to reason that if you use some of your hard-earned money to buy yourself more time — for example, by paying someone to clean your house or mow your lawn — you might achieve a greater level of happiness? Indeed, that was the primary finding in a series of studies by Professor Dunn and other researchers published in the Proceedings of the National Academy of Sciences (PNAS).[2]

The discovery

The study's authors surveyed 6,000 individuals at diverse income levels in multiple countries, including the United States, Canada, the Netherlands, and Denmark. The surveys queried participants about whether they spent money on a monthly basis to hire others to take care of unpleasant or time-consuming daily tasks or chores — such as cleaning, yard work, cooking, and errand-running — and if so, how much they spent. Respondents were also asked to rate their "satisfaction with life" and report demographic information, such as their income level and whether they were married and had children.

Researchers found that across all national samples, 28.2% of respondents spent an average of about $148 per month to outsource disliked tasks, while in the United States, 50% of respondents spent an average of $80 to $99 on services that save time. Across all studies, those who spent money to outsource disliked tasks and/or save time had a stronger life satisfaction rating. Findings were consistent across income spectrums; in fact, in the United States, researchers found a stronger correlation among the less-affluent respondents. The authors noted, however, that their studies did not include enough people at the lowest end of the income spectrum to attribute similar findings to this group.

Of course, correlation does not necessarily indicate causality, so the researchers designed a follow-up experiment to further test their hypothesis.

In this experiment, researchers gave a group of 40 adults $80 each to spend over the course of two weekends. During the first weekend, they were to spend $40 on something that would save them time, such as ordering groceries online and having them delivered. On the second weekend, they were directed to spend $40 on a nice material purchase, such as clothes, board games, or a bottle of wine. On average, those who spent money to save time reported better moods at the end of the day than those who purchased material goods. And according to the researchers, over time, the effect of regular mood boosts can add up to greater overall satisfaction with life.

In a third study, researchers asked respondents how they would spend an extra $40. Just 2% indicated they would use the unexpected bonus to invest in time-saving services.

Perhaps most surprising of all the findings? Researchers polled 800 millionaires from the Netherlands about whether they spent money to save time. Despite the fact that these individuals could readily afford to hire others to take care of time-consuming tasks, only about half of them reported doing so on a monthly basis. Researchers surmise that the reason might be because such individuals feel guilty or don't want to be perceived as lazy for outsourcing chores they can easily do themselves.

The lesson

"If you have a lot of money and a lot of nice stuff, but you're spending your time doing things that you dislike, then your minute-to-minute happiness and overall happiness is likely to be pretty low," said Dunn in an interview about the research.[3] In the PNAS report, the study's authors contend that this may be especially true for women:

"Within many cultures, women may feel obligated to complete household tasks themselves, working a 'second-shift' at home, even when they can afford to pay someone to help. In recent decades, women have made gains, such as improved access to education, but their life satisfaction has declined; increasing uptake of time-saving services may provide a pathway toward reducing the harmful effects of women's second shift."

The bottom line? If you can afford it, don't shy away from spending money to save time. Doing so is an investment that provides immeasurable returns in the form of overall well-being.

[1] "What Is Your Time Really Worth?" Elizabeth Dunn, TEDx Colorado Springs, December 1, 2014

[2] "Buying Time Promotes Happiness," PNAS, July 24, 2017

[3] "A Psychology Expert Says Spending Your Money on This Can Boost Your Happiness," CNBC, November 10, 2017

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What are the gift and estate tax rules after tax reform?

The Tax Cuts and Jobs Act, signed into law in December 2017, approximately doubled the federal gift and estate tax basic exclusion amount to $11.18 million in 2018 (adjusted for inflation in later years). After 2025, the exclusion is scheduled to revert to its pre-2018 level and be cut approximately in half. Otherwise, federal gift and estate taxes remain the same.

Gift tax. Gifts you make during your lifetime may be subject to federal gift tax. Not all gifts are subject to the tax, however. You can make annual tax-free gifts of up to $15,000 per recipient. Married couples can effectively make annual tax-free gifts of up to $30,000 per recipient. You can also make unlimited tax-free gifts for qualifying expenses paid directly to educational or medical service providers. And you can make deductible transfers to your spouse and to charity. There is a basic exclusion amount that protects a total of up to $11.18 million (in 2018) from gift tax and estate tax. Transfers in excess of the basic exclusion amount are generally taxed at 40%.

Estate tax. Property you own at death is subject to federal estate tax. As with the gift tax, you can make deductible transfers to your spouse and to charity; there is a basic exclusion amount that protects up to $11.18 million (in 2018) from tax, and a tax rate of 40% generally applies to transfers in excess of the basic exclusion amount.

Portability. The estate of a deceased spouse can elect to transfer any unused applicable exclusion amount to his or her surviving spouse (a concept referred to as portability). The surviving spouse can use the unused exclusion of the deceased spouse, along with the surviving spouse's own basic exclusion amount, for federal gift and estate tax purposes. For example, if a spouse died in 2011 and the estate elected to transfer $5 million of the unused exclusion to the surviving spouse, the surviving spouse effectively has an applicable exclusion amount of $16.18 million ($5 million plus $11.18 million) to shelter transfers from federal gift or estate tax in 2018.

Should I enroll in a health savings account?

A health savings account (HSA) is a tax-advantaged account that you can establish and contribute to if you are enrolled in a high-deductible health plan (HDHP). Because you shoulder a greater portion of your health-care costs, you'll usually pay a much lower premium for an HDHP than you would pay for traditional health insurance. This allows you to contribute the premium dollars you're saving to your HSA. Then, when you need medical care, you can withdraw HSA funds to cover your expenses, or opt to pay your costs out-of-pocket if you want to save your account funds. An HSA can be a powerful savings tool, especially if your health expenses are relatively low, since you may be able to build up a significant balance in your HSA over time. Before you enroll in an HSA, ask yourself the following questions:

What will your annual out-of-pocket costs be under the HDHP you're considering? Estimate these based on your current health expenses. The lower your costs, the easier it may be to accumulate HSA funds.

How much can you afford to contribute to your HSA every year? Contributing as much as you can on a regular basis is key to building a cushion against future expenses. For 2018, you can contribute up to $3,450 for individual coverage and $6,900 for family coverage.

Will your employer contribute to your HSA? Employer contributions can help offset the increased financial risk that you're assuming by enrolling in an HDHP rather than traditional employer-sponsored health insurance.

Are you willing to take on more responsibility for your own health care? For example, to achieve the maximum cost savings, you may need to research costs and negotiate fees with health providers when paying out-of-pocket.

How does the coverage provided by the HDHP compare with your current health plan? Don't sacrifice coverage to save money. Read all plan materials to make sure you understand benefits, exclusions, and all costs.

What tax savings might you expect? HSA funds can be withdrawn free of federal income tax and penalties provided the money is spent on qualified health-care expenses. Depending on the state, HSA contributions and earnings may or may not be subject to state taxes. Consult your tax adviser for more information.

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