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Ask the Experts: Financial FAQs (Winter 2018)

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Q: How is the tax reform that recently passed going to affect the economy and the capital markets?

A: The Tax Cuts and Jobs Act that President Trump signed into law in late December is the largest change to the tax code in 30 years and affects both individuals and corporations. It will have a dramatic impact on the economy and is significant in several ways.

Most Americans will feel the Tax Cuts and Jobs Act's effects in the first months of 2018 as their take-home pay ticks up slightly due to lower withholding and reduced tax tables. This increase in cash flow will put approximately $100 billion more in American's pockets in 2018, and it will drive consumer spending and consumer confidence.

Corporations have even more to gain as the corporate tax rate falls from 35 percent to 21 percent, bringing the U.S. from the highest corporate tax rate among the world's 10 largest economies to second behind the United Kingdom—and ahead of China at 25 percent. The magnitude of this drop will both fuel corporate profits and make U.S. corporations much more competitive against their foreign peers.

The Tax Cuts and Jobs Act also includes incentives for corporations to ramp up their investment in people, research, and plant and equipment, paving the way for future growth. More than 100 corporations have already announced wage increases or bonuses in anticipation of increased profitability. This will further fuel consumer spending.

Our expectation is that the Tax Cuts and Jobs Act will boost the economy to a level not seen in more than a decade. Currently, the consensus estimate for gross domestic product (GDP) in 2018 is 2.5 percent. We believe the tax deal will boost GDP by 1 percent and that 2018 growth will exceed 3 percent—and could accelerate to near 4 percent.

If history is a guide, stock market investors have reason to be optimistic as well. While there is only a handful of tax cuts to analyze, our research indicates that the stock market (as measured by the S&P 500) was higher one, three, five, and ten years after past tax cuts in 1964, 1965, 1981, 1986, 2001, and 2003. Interestingly, the Tax Cuts and Jobs Act's personal income tax rate reduction is small compared to past cuts, but the corporate tax rate cut is much larger.

Of course, potential downsides exist as well. If all this additional consumer spending heats the economy up too much, we may see a level of inflation that spooks the Federal Reserve— causing it to hike interest rates faster—and constrains the markets. And the mortgage interest deduction cap (more on this below) may also hinder the appreciation of higher-priced homes relative to lower-priced homes.

Q: How will my personal income taxes change as a result of the Tax Cuts and Jobs Act?

A: Tax law changes are always a little confusing, and, since everyone's situation is unique, it can be hard to foresee the net impact on your personal tax situation. The Tax Cuts and Jobs Act is no exception. The good news is that you should expect to pay less and that paying your taxes becomes simpler starting in 2019 for your 2018 income.

Below are some highlights of the new tax rules:

- Seven income tax brackets remain, with the top tax bracket dropping from 39.6 percent to 37 percent. All other brackets shift down slightly. Effective tax rates are lowered across the board.
- The standard deduction increases to $24,000 for taxpayers filing jointly and $12,000 for single filers. That's up from $12,700 and $6,350, respectively. Personal exemptions are eliminated. This means that roughly 94 percent of taxpayers will now likely take the standard deduction, up from roughly 72 percent before.
- State and local tax (SALT) deductions are capped at $10,000 for individuals and married couples and $5,000 for those married filing separately. Previously, there was no cap. This will impact residents of high-income-tax states the most.
- The mortgage interest deduction is capped at the first $750,000 of debt principal on new mortgages after December 15, 2017, and the deduction for home equity interest has been eliminated.
- Miscellaneous itemized deductions are suspended. Previously, deductions were available above 2 percent of adjusted gross income (AGI) for tax preparation fees, investment advisor fees, professional dues, and unreimbursed employee business expenses, including agent fees for athletes.
- For taxpayers who still itemize deductions on their returns, the deduction for charitable contributions of cash goes up to 60 percent of AGI—up from 50 percent.
- The estate tax exemption rises from a scheduled $5.6 million to $11.2 million for individuals and from a scheduled $11.2 million to $22.4 million for couples. Couples can now transfer up to $22.4 million out of their estates tax-free.
- The alternative minimum tax (AMT) remains, but the exemption increases from $84,000 to $109,400 for couples and $54,300 to $70,300 for all others. The exemption phases out at $500,000 for singles and $1,000,000 for joint filers.
- The child tax credit for dependent children under the age of 17 goes from $1,000 to $2,000. Phaseouts increase from $75,000 to $100,000 for individual taxpayers and $200,000 to $400,000 for joint taxpayers. There is a new $500 credit for each non-child dependent, such as an elderly parent or college-age child.

Most people will have higher taxable incomes under the new rules due to the caps on mortgage interest and state and local tax deductions and elimination of personal exemptions. However, they will pay less due to lower tax rates and the higher alternative minimum tax exemption. While approximately 95 percent of Americans will pay less, high-income earners in states with high property taxes, such as New York, New Jersey, and California, may pay more.

The Tax Cuts and Jobs Act also includes some provisions that will affect the owners of passthrough entities such as subchapter-S corporations, partnerships, and sole proprietorships. While they don't apply to companies in all industries, the combination of lower personal income tax rates and a new deduction for passthrough income should result in lower taxes for small-business owners.

Remember that CAPTRUST does not render legal, accounting, or tax advice, so if you need help, please consult an appropriate legal, accounting, or tax advisor to address your specific questions or circumstances.

Have questions? Need help? Call the CAPTRUST Advice Desk at 800.967.9948, or schedule an appointment with a retirement counselor today.