

My Views from Wall St. to Center St.

*"Don't tax you, don't tax me, tax that fellow behind the tree" – Senator Russell Long,
Chairman, Senate Finance Committee, 1966-1981*

This past year, Halloween was barely over when House Republicans introduced their version of tax reform. Few observers thought such a massive undertaking could be signed into law within seven short weeks. But that is exactly what happened. In the hectic days that preceded Christmas, the president signed into law the most sweeping change in the tax code since 1986.

"The legislation will result in substantive tax reform for corporations, with the elimination of the corporate alternative minimum tax (AMT) and consolidation down to a single 21% tax rate (from 35%), all of which are permanent," Michael Kitces, a respected authority on tax issues, wrote on Kitces.com.

"However," he added, "When it comes to individuals, the new legislation is more of a series of cuts and tweaks, which arguably introduce more tax planning complexity for many, and will be subject to another infamous sunset provision after the year 2025."

I know the often-stated goal of tax reform was simplification. But simplification means that much lower tax brackets can only be achieved if cherished deductions and credits are done away with.

It's easier said than done. Sure, simplification is a lofty ideal, but, "Don't take my deductions or credits from me," has always been the taxpayers' battle cry. And yes, Congress heard and listened to several of those pleas. While some deductions will disappear, others remain or have been reduced. Senator Long probably would have sported a grin when President Trump signed the massive bill.

Sharpen your pencils — the new tax code and tax planning

Over 80% of Americans will get a tax cut next year, while just 5% of taxpayers are expected to pay more (Tax Policy Center, Washington Post). In most cases, cuts are expected to be modest; however, much will depend on individual circumstances.

Due to the complexities of the new law, I am always happy to talk with you, but I also encourage you to check with your tax advisor. Many experts are struggling with the details of the bill, and that's to be expected this early in the game.

What I would like to do is touch on the high points. It's not all-inclusive and not a deep dive, but given many of your questions lately, I believe an overview is in order.

So, let's get started. (Sources for this review include Kitces.com and the Tax Policy Center.) This applies to tax year 2018.

1. The 10% bracket remains unchanged, while the 15% bracket declines to 12%, the 25% to 22%, the 28% to 24%, the 33% to 32%, the 35% holds steady, and the 39.6% slips to 37%. The thresholds are modestly adjusted above the new 22% bracket.
2. The standard deduction nearly doubles to \$12,000 for single filers and \$24,000 for married filers, reducing the incentive to itemize and simplifying for some taxpayers.
3. The \$4,150 personal exemption is eliminated, and the \$1,000 child tax credit doubles to \$2,000. In general, rules for charitable contributions remain unchanged. By itself, the combination of points one, two, and three will provide modest tax relief for most families. But I must caution, it depends on your individual circumstances.
4. Those in high-tax states could see the biggest hit, as there will be a \$10,000 cap on state, local and property tax deductions.
5. For investors, the preferential treatment for long-term capital gains and dividends remains intact, as is generally the case for retirement accounts. One important change — the new law repeals rules that allow for recharacterizations of Roth conversions back into traditional IRAs. Once you convert into a Roth, there's no going back.
6. The 3.8% Medicare surtax on investment income for high-income taxpayers was retained. Since the levy entered the tax code, we have crafted strategies that reduce its bite; however, the tax survived tax reform and is likely to remain a permanent feature of the tax code going forward.
7. The AMT for individuals was not repealed, but exemptions have been widened. According to the Tax Foundation, Congress passed the AMT in 1969 after the Secretary of the Treasury said 155 people with adjusted gross income above \$200,000 had paid no federal income tax on their 1967 tax returns. The AMT was never adjusted for inflation and grew into an onerous feature for many Americans. In inflation-adjusted terms, those 1967 incomes would be roughly \$1.2 million in today's dollars. Ideally, it would have been eliminated from the tax code. But Kitces points out, "While the AMT commonly impacted those around \$150,000 to \$600,000 of income, in the future, AMT exposure will be much smaller, and it will be extremely difficult to be impacted at all, especially given more limited deductions."
8. The estate tax survived, but the exemption will double from \$5.6 million to \$11.2 million, and \$11.2 million to \$22.4 million for couples.
9. The new tax bill also repeals the Obamacare mandate that requires all individuals to obtain health insurance. It becomes effective 2019. Finally, it's important to point out that many of the more popular changes in the tax code for individuals will sunset in 2025. While many may eventually be made permanent, as we saw with the Bush tax cuts of 2001 and 2003, there's no guarantee this will happen again.
10. And for businesses: Given that the 21% corporate tax rate applies only to C-corps, there will be a 20% deduction for pass-through entities, such as S-corps, partnerships, and LLCs. I believe this will be a welcome benefit for many business owners, but complex rules may limit the pass-through for some entities.

Final thoughts

I fully expect that the rewrite of the tax code will produce unintended benefits and unexpected consequences. From an economic standpoint, Congress and the president hope to unleash the "animal spirits" that have been lethargic for much of the economic expansion. They hope that changes, especially as they relate to business, will encourage firms to open new plants, expand in the U.S., and level the playing field with the global community. Prior to reform, the U.S. corporate rate was the third highest among 188 nations (Tax Foundation).

The \$64 billion-dollar question — will it work? About 90% of economists surveyed by the Wall Street Journal expect a modest boost to growth in 2018 and 2019, but after that, opinions diverge. If tax incentives boost productivity, it could lift long-run GDP potential, which would yield a significant benefit. If the economic benefits end after a two-year sugar high, it will likely be deemed a failure.

Early anecdotal data offer some encouragement, as several large firms announced year-end bonuses or wage hikes tied to the lower corporate tax rate. At a minimum, the lower tax rate increases longer-run after-tax earnings, which played a big role in the late-year stock market rally. It could also boost corporate stock buybacks and dividends going forward, which would create an added tailwind for stocks. That said, I'm cautiously optimistic it will encourage entrepreneurship and economic growth, which would benefit hard-working Americans.

Again, I understand that uncertainty breeds questions and concerns. If you would like to talk, I'm simply a phone call or an email away. I'd be happy to talk with you and answer any questions you may have.

Happy New Year and a Peek at 2018

I've been in the financial planning field for many years. I've been inundated with articles and soothsayers that offer up specific roadmaps for stocks. None have been consistently right. That said, let's use simple math to guide us as we enter 2018.

The S&P 500 Index advanced 21.83% in 2017. That figure includes reinvested dividends. No question about it, 2017 offered rich rewards to those who invested in a well-diversified stock portfolio. So, does a sharp upward advance in one year set the stage for a pullback in the following year? Not if we use the historical data as our guide. I recognize that the following examples are a little heavy on numbers, but please stick with me. I believe you'll find the evidenced-based approach to be quite enlightening.

Since 1950, the S&P 500 has risen at least 20% (including reinvested dividends) 24 times (excluding 2017). In the year that followed, the S&P 500 finished higher (all examples include reinvested dividends) 19 times. Put another way, the S&P 500 rose 79.2% in the year that followed a 20% or greater advance, with an average gain of 18.1%. (Here is the link to the http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html raw data].)

Since 1950, the S&P 500 (including reinvested dividends) has finished higher 79.10% of the time, excluding 2017. The average advance when the S&P 500 finished higher (looking only at years that finished positively) was 19.1%. When the S&P 500 has declined following a 20% + advance, the average drop has been 6.5%.

Based purely on the example above, last year's impressive advance has little predictive value, with one exception. It simply tells us that stocks have an inherent upward bias over the longer term. I should also add that upward bias is a key component embedded in your financial plan.

What will impact shares next year? Longer term, it's always about the fundamentals, i.e., economic growth and profit growth. Low inflation and low interest rates only sweetened the pot last year. The momentum generated by a growing U.S. and global economy is likely to carry over into the new year.

While a 2018 recession can't definitively be ruled out, leading indicators suggest the odds are low. That said, unexpected events can create short-term emotional responses in the market that are best avoided by long-term investors. Last year's lack of volatility was simply remarkable. According to data from LPL Research and the St. Louis Federal Reserve, the biggest drop in the S&P 500 amounted to just 2.8%. It was the smallest decline since 1995. The average intra-year pullback for the S&P 500: 13.6% (LPL Research). It's an excellent reminder that volatility is typically a part of the investment landscape. It can sometimes be unnerving, but it's incorporated into the investment plan we've recommended for you.

Table 1: Key Index Returns

| | MTD% | YTD% | 3-year*% |
|---|------|-------|----------|
| Dow Jones Industrial Average | +1.8 | +25.1 | +11.1 |
| NASDAQ Composite | +0.4 | +28.2 | +12.8 |
| S&P 500 Index | +1.0 | +19.4 | +8.5 |
| Russell 2000 Index | -0.6 | +13.1 | +8.0 |
| MSCI World ex-USA** | +1.7 | +21.0 | +4.6 |
| MSCI Emerging Markets** | +3.4 | +34.4 | +6.6 |
| Bloomberg Barclays US Aggregate Bond TR | +0.5 | +3.5 | +2.2 |

Source: Wall Street Journal, MSCI.com, MarketWatch, Morningstar

MTD returns: Nov. 30, 2017—Dec. 29, 2017

YTD returns: Dec. 30, 2016—Dec. 29, 2017

*Annualized

**In U.S. dollars

I hope you've found this review to be educational and helpful. Let me emphasize again that it is my job to assist you! If you have any questions or would like to discuss any matters, please feel free to give me or any of my team members a call. Once again, before making any decisions that may impact your taxes, please consult with your tax advisor.

Personal Note ~

Januarys are an eventful month for everyone I suppose. We close the book on the previous year and set our sights on the New Year. For many of you, myself included, we set out to execute our "resolutions" to improve our "future self." Good luck to you all in achieving your goals!

Personal Note – cont. ~

This January has been a very sad month in my family. On January 18th my mother-in-law, Suzanne Berry passed away after a 15 year battle with Parkinson's. Parkinson's is an insidious disease that eats away at your physical body a little at a time, day after day, year after year. Suzanne, handled her fight with the disease with the same determination, elegance, poise, and humor that she displayed during her "healthy life." Suzanne was the best mother-in-law any husband could hope to have. She was supportive and never "meddled" in our lives. We joke, although it's true, that Suzanne did not initially approve of me, but over the years she became one of my biggest allies. She trusted me to marry her daughter, raise 3 of her grandchildren (she had 9), manage her financial affairs, make critical medical decisions regarding Jennifer when she was undergoing cancer treatment at Duke. As a parent with adult aged children, I know that trust does not come easy. I will do my best to continue to honor that trust. So I ask everyone reading this to raise a glass and toast and/or say a prayer in tribute to Suzanne Berry. You will be missed on this earth by your family and friends. Goodbye.

As always, I'm honored and humbled that you have given me the opportunity to serve as your financial advisor.

As 2018 gets underway, I want to wish you and your loved ones a happy and prosperous new year!

Jeff

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