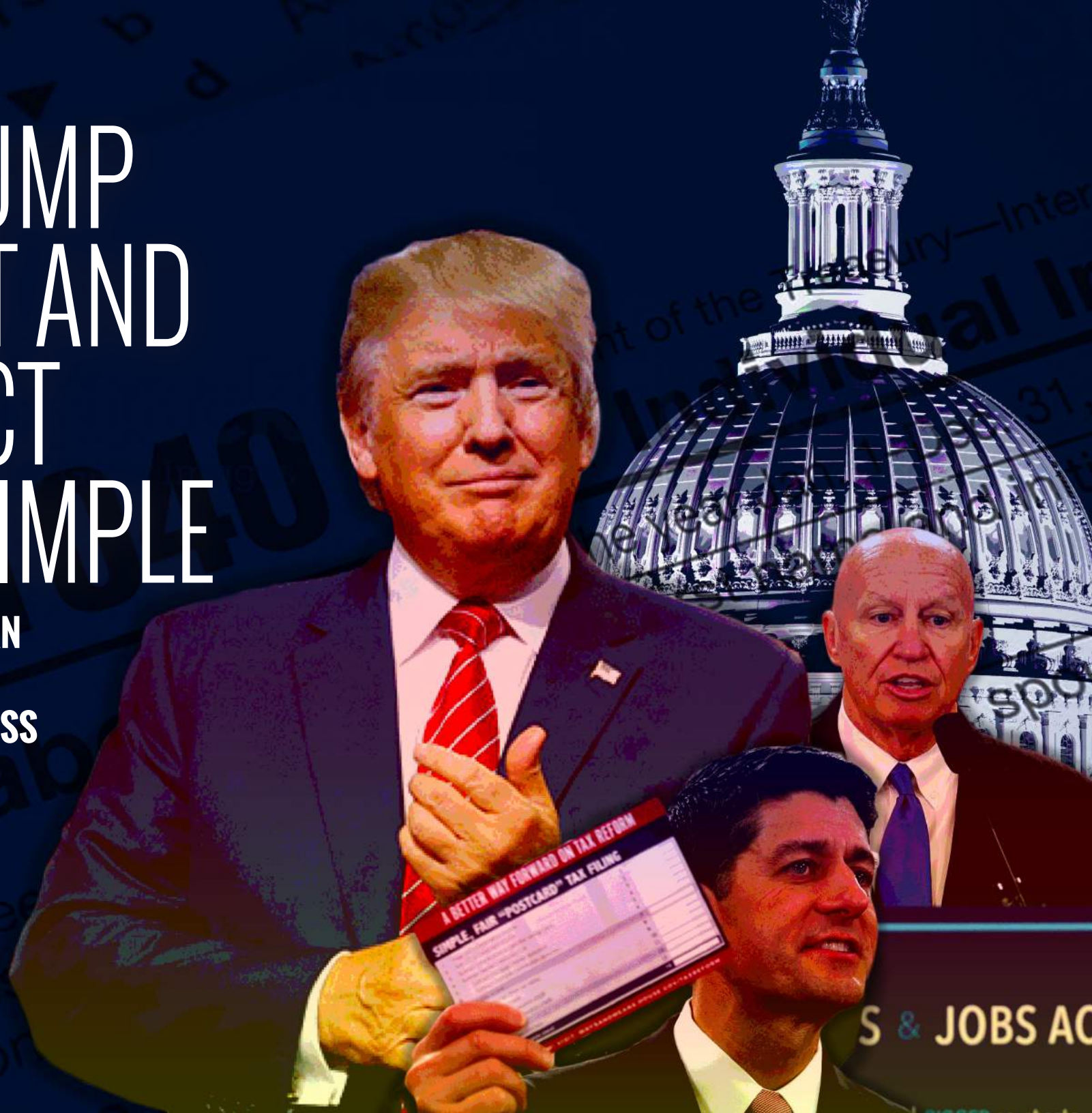
THE TRUMP TAX CUT AND JOBS ACT MADE SIMPLE

SEVEN WAYS YOU CAN USE TAX REFORM TO BUILD YOUR BUSINESS



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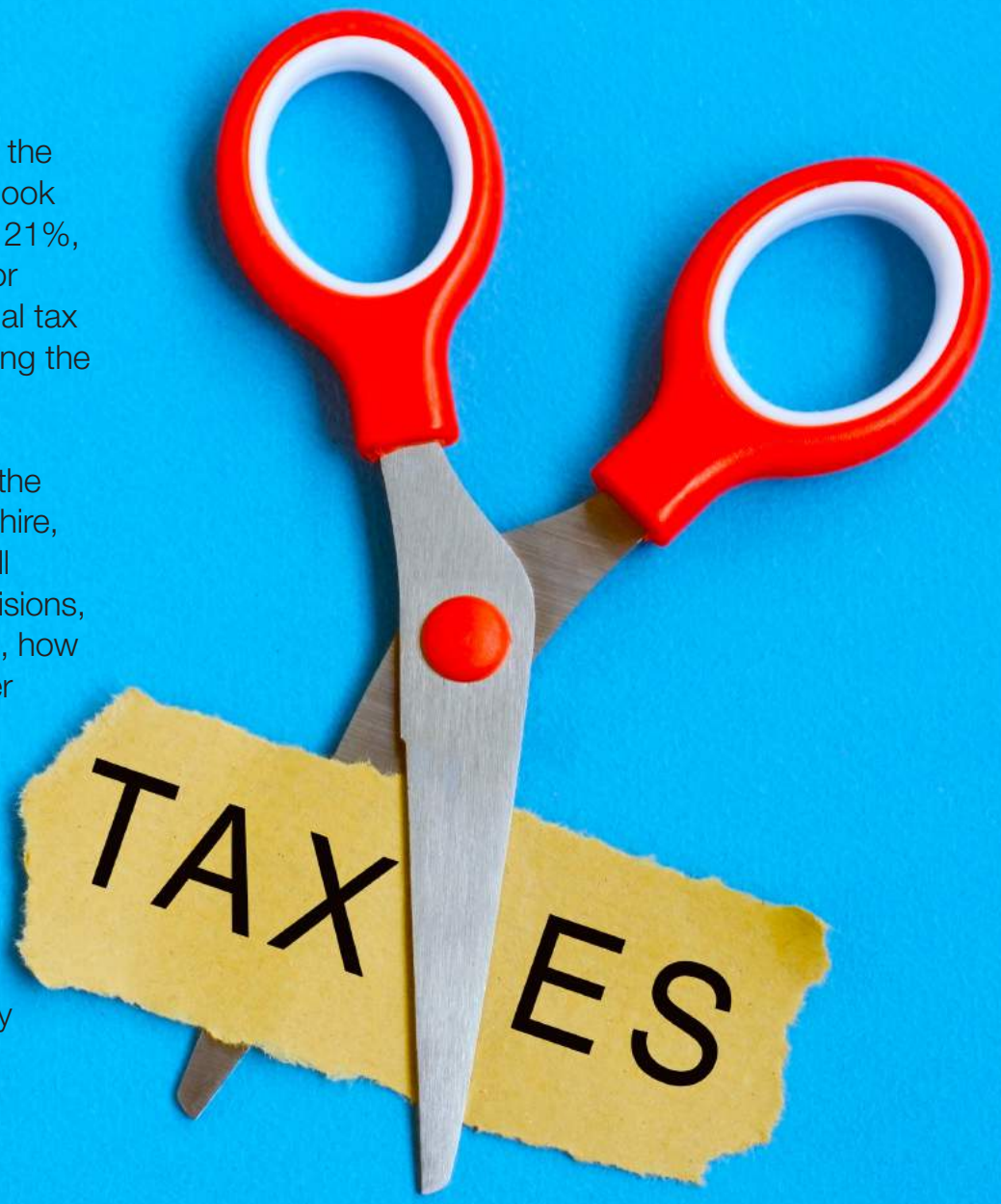
TAX REFORM IS HERE. On January 1, the massive and far-reaching Tax Cuts and Jobs Act took effect, cutting the corporate tax rate from 35% to 21%, creating a new pass-through income deduction for unincorporated businesses, reconfiguring individual tax rates, eliminating many deductions, and overhauling the estate and gift tax.

The new tax bill will affect nearly every segment of the American economy, changing the way companies hire, invest, and return value to shareholders. The bill will transform how families make a broad range of decisions, from where to live, how much to spend on a home, how to finance their kids' education, and how to transfer assets to the next generation.

The new law was written quickly and signed into law just days before it took effect. That means that very few of your clients and prospects understand how tax reform will affect them – or how they can turn its provisions to their advantage. As a result, financial advisors now have an incredible opportunity to serve their clients and expand their business by explaining the new law and showing clients how to benefit from it. Here are six ways you can use tax reform to build your business in 2018.



1 TAKE ADVANTAGE OF THE PASS-THROUGH DEDUCTION FOR YOUR COMPANY

One of the most interesting features of the new tax law is a special 20% deduction for pass-through entities – that is any company that is not structured as a C corporation, be it an S corp, an LLC, or a sole proprietorship. The deduction is available to anyone, in any business, with income up to $157,000 for an individual or $315,000 for a married couple filing jointly.

For financial advisors, there are two important applications. First, look at your own business. It may be worth reclassifying income as deriving from your stake in some sort of pass-through business structure — an S corporation, partnership, LLC, or sole proprietorship. As an individual employee you simply owe a slice of your income to the IRS, but when you contribute your labor to the business and take the profit out of the back end, Congress will let you deduct 20% before taxes apply.

It is true that income limits apply. If you make more than $157,000 (as an individual) or $315,000 (as part of a married couple), you can take the pass-through deduction only on income equal to 50% of wages and/or 2.5% of capital expenses. Bob Keebler, CPA/PFS, MST, AEP (Distinguished), CGMA, a partner at Green Bay, Wisconsin-based Keebler & Associates, explains, "For example, if you earn $1 million and pay $250,000 in wages, you could only apply the pass-through deduction to 50% of $250,000 in wages, not to the entire $1 million in income." Similarly, business owners over the income limit can take the deduction on 2.5% of capital expenses (though since financial advice is not a capital-intensive business, this provision will likely come into play less often than the wage test).

Bob Keebler says that business owners just over the limit should take a hard look at their income and expenses; it may be worth it to reduce income under the threshold. "I think the big thing is going to be setting up defined benefit plans," says Keebler, noting that traditional pension plans allow much higher contributions than 401(k)s or other defined contribution structures.

2 WHAT ABOUT YOUR CLIENTS' TRUSTS

In addition to the personal application, the pass-through deduction also applies to trusts that own pass-through entities like partnerships and LLCs. In a last minute change, however, the bill exempted capital intensive businesses like real estate partnerships from the income limits, so trusts with these kinds of assets can take the 20% deduction regardless of how much money they earn.

Even trusts that do not invest in real estate — and thus are not exempt from the income limits and wage tests— can take the pass-through deduction if they earn income of less than $157,000. Remember, that means income from the trust itself, not the investor, so even fairly large trusts may qualify. For instance, a trust with $2.5 million in assets earning 6% or less annually would meet the income limit. Moreover, there's nothing to stop investors from setting up multiple trusts, rather than one big one, to skirt the income rule. "If you have ten grandkids, you can create 10 trusts," says Keebler.

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DOUBLE UP ON DYNASTY PLANNING

The tax package effectively doubles the estate, gift, and generation skipping tax from $5 million per individual in 2017 to $11.2 million in 2018. Those amounts double for people who are married and filing jointly. That means that estates up to $22 million in value are not subject to federal estate tax – though some will be liable for a state level estate tax.

Experts say that the new higher exemption creates an opportunity for setting up or expanding dynasty trusts, effectively removing additional money from the estate even if the exemption shrinks in future years. Bob Keebler explains, "Let's say that today, before tax reform, I have a $5 million exemption and I've already used it. I'm worth $25 million. I don't need much money to live on. I've used my $5 million. As soon as it goes up by $5, if I have $5 million in cash, I'm giving away the next five. And I would put that in a dynasty trust."

The estate tax exemption is set to revert back to the original $5 million amount in 2026, and there is no guarantee that future tax reform legislation won't reduce it even before that date, so most planners suggest that families take advantage of it now. "We're telling people to use this opportunity to continue to plan," says Doug Mueller, CPA, the president and co-founder of St. Louis-based accounting firm, Mueller Post "Hope for the best. Plan for the worst, because administrations can change."

MANAGE STATE TAXES WITH TRUSTS

Under the new law, tax filers can deduct a maximum of just $10,000 in state and local taxes on their Federal Return, a provision that will significantly increase taxes for people who live in high tax states like New York and California.

"We're going to be putting a greater emphasis on income tax planning rather than estate tax planning going forward," says Steve Oshins, a partner at the Nevada-based law firm Oshins and Associates. "We'll be putting a greater emphasis on saving state income taxes using special types of trusts."

Oshins is speaking, specifically, about non-grantor trusts, which are taxed based on where the trust is domiciled, not where the grantor lives. They allow individuals to move assets — and the income from those assets — from high tax states to low or no tax states. In California, for instance, the top marginal income tax rate is 13.3% while neighboring Nevada has no state income tax.

"We will be doing a lot of Nevada Incomplete Gift Non-Grantor Trusts (NINGs), to save state income taxes," says Oshins. "We were already doing tons of these trusts, but now that state income taxes are no longer deductible against Federal taxes, that is an even greater incentive for people to want to form a NING trust in order to save on state income taxes."

Oshins says his firm will also be looking for opportunities to decant existing grantor trusts (again taxed according to the grantor's home state laws) into non-grantor structures.

Mueller adds that the very wealthy may also consider relocating. "Now when you can no longer deduct your income taxes, you might see more and more people thinking about where they live for state tax purposes," he notes. And where actually moving is too onerous, moving assets may provide a solution. "Steve's business ought to flourish next year," he adds.

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5 PREPARE FOR THE BUYBACK BOOM

No less an expert than Warren Buffett maintains that the impact of tax reform on the stock market will be "huge," and as of mid-January 2018, had not been fully reflected in security prices. That suggests that the stock market offers exceptional opportunities to investors right now.

Why? First because the new law dramatically reduces corporate income taxes from 35% to 21%, which will significantly increase companies' ability to expand, invest, and return value to shareholders through dividends and buybacks. In addition, a new rule aimed at repatriating foreign cash piles earnings will allow companies to pay a one-time tax of between 8% and 15.5% on overseas earnings made since 1987. Once this payment is made, companies can bring that money back to the U.S. without paying regular income taxes, which top out at 21% under the new rule.

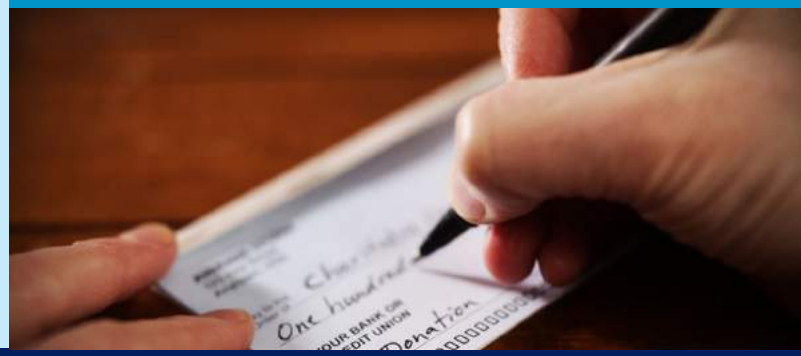
Companies in the S&P 500 currently have about $1.2 trillion in profits overseas and they have been itching to bring that money back. High taxes have been the main impediment. The new rules end their ability to defer those taxes, but also lower the hit significantly, so we can expect a flood of returning capital. Much of it will go to shareholders – in fact, Bank of America recently estimated that nearly half that total (after taxes) or $450 billion will go towards stock buybacks. That will, alongside the increased growth potential caused by lower taxes, create a powerful tailwind for stocks. 2018 looks to be an excellent year for your clients to maintain or increase their exposure to equities.

6 BE STRATEGIC ABOUT CHARITABLE GIVING

The good news? Your clients can still take charitable deductions. The bad? Many of them will decide it is not worth the trouble. The standard deduction nearly doubles in 2018 from $6,350 to $12,000 for individuals from $12,700 to $24,000 for married couples filing jointly, so far fewer people will find it makes sense to itemize. A married couple already claiming the maximum $10,000 in state and local tax deductions would have to make gifts of over $14,000 per year to get any tax benefit over the standard deduction.

"For somebody that sits down and writes a check for $1000 once a year, that is, for a lot of folks, there's not going to be a charitable deduction going forward," says Sweet. "But for the higher income folks that we work with, we're trying to find a way to be tax efficient where they can still take advantage of the rules. The deductibility isn't going away, it's just that the rules have changed a little bit.

Sweet continues, "We're advising a number of our clients to make their charitable contributions through donor-advised funds and lump all those contributions into one year. And so for example if you're going to give $10,000 a year for the next five years, basically do the donation to a donor-advised fund in a $50,000 lump sum up front in one year, take the donation and then through that advised fund then donate the assets to charity in the future."



7 EXPAND YOUR BUSINESS IN 529 PLANS

"Probably the number one question that I would get from clients relating to 529 plans was 'Can I use 529 assets for primary or secondary school?' The answer up to 2018 was no," says Bill Sweet, CFP, an investment advisor at New York-based Ritholtz Wealth Management. That all changed with tax reform which changed the law to allow 529s to fund private elementary and high school expenses. "This is a new ballgame," adds Sweet.

Is it a good idea to use 529 funds starting in kindergarten? It depends. Some parents may run out of money if they start withdrawing too early, and all will miss out on the long-term benefits of compounded returns.

Mueller says, however, that the new rules are a real benefit, despite this limitation. "You might not get much growth, investing for primary school, but for grandmas and grandpas who are doing some estate planning, the new rules provide an opportunity to start giving. I think you can make a case for funding high school with 529s – there you have more than a decade of potential growth."

The bottom line: 529 plans just got a lot more useful for a lot more families. If you have clients or prospects with school-aged children or grandchildren, now is a good time to revisit this topic.