CALLAN CAPITAL

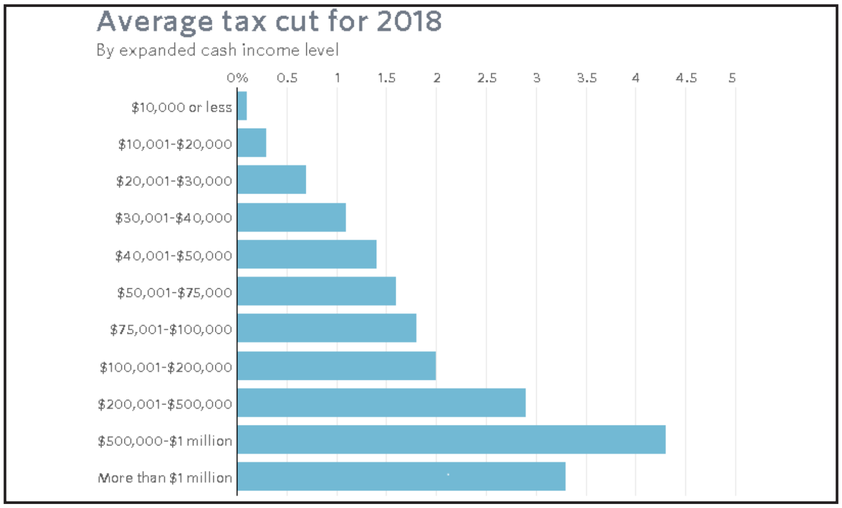
CALLAN CAPITAL GUIDE: IMPLICATIONS OF THE TAX CUTS AND JOBS ACT OF 2017

+ WHAT ARE THE CHANGES

President Trump approved the Tax Cuts and Jobs Act of 2017 right before Christmas, and it has now been signed into law. As a result of multiple versions of the Act being circulated and debated in headline news stories, many investors wonder exactly what the final 1,000-page bill entails, how it affects them personally and what the short and long-term implications are for the economy and investment portfolios. While the motivation of the tax reform movement came from a desire to cut corporate taxes, most of the benefits will help individual taxpayers.

For individuals, in general, there are lower tax brackets and thresholds. The largest percentage decrease is in the highest tax bracket, with the rate decreasing from 39.6% to 37%. The bill virtually eliminates Alternative Minimum Tax (AMT), and limits state and local income tax deductions to $10,000. The standard deduction is doubled, and personal exemption is eliminated. The mortgage interest deduction is eliminated (except for the first $750,000), and current mortgage holders are grandfathered in.

Percentage Decrease in Taxes Per Income Level



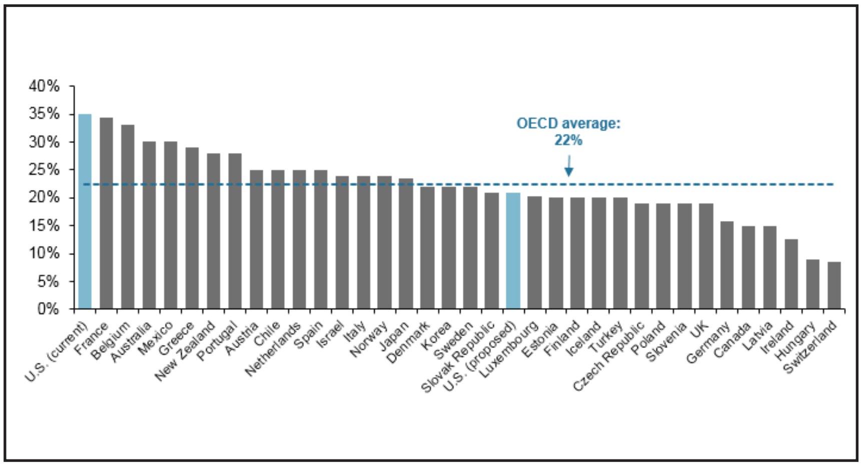
Source: Tax Policy Center

The rules for qualified education related expenses for 529 plans are expanding to allow for $10,000 per year to be used for K-12 education. In addition, the child tax credit is doubled. Lastly, the bill repeals the individual Affordable Care Act mandate, not requiring all individuals to be insured. Moving expenses are no longer deductible, other than for those in the military.

Depending on factors such as income, state of residence and home ownership, individuals and families may pay more or less than they currently do. For example, high wage earners in a no-tax state could see savings, while high wage earners in a high tax state like California could see a higher tax bill.

On the corporate side, the tax rate for corporations has decreased to 21% from 35%, and Alternative Minimum Tax (AMT) has been eliminated. There is a reduced rate on pass-through entities, and a one-time repatriation tax for U.S. corporations. In addition, corporations can now expense 100% of their investment spending. Prior to this bill, the U.S. had the highest corporate tax rate in the world; now, it is slightly below average as shown in the chart below.

Corporate Tax Rates Per Country



Source: JP Morgan Asset Management

According to the Joint Committee on Taxation, the fiscal deficit will increase by $1.46 trillion over the next decade. Though this number is significant and these changes can be overwhelming, taxpayers won't need to worry about these changes when filing 2017 taxes, as they will only be applicable for 2018 taxes. In addiion, most of the new rules sunset in 2015. We encourage you to consult a tax advisor to see if there are any strategies you can employ in 2017 and beyond to help minimize taxes.

+ CHANGES TO ESTATES AND WEALTH TRANSFER

Under the Tax Cuts and Jobs Act of 2017, there are changes to wealth transfer rules that could impact investors. New estate planning rules are positive for wealthy families.

Under the new rules, a husband and wife can how pass tax-free almost $22 million worth of estate value to their heirs – an increase of $5.49 million per person to $10.98 million per person. This is significant – and translates into a savings of almost $4.4 million for heirs of estates. However, the tax rate of 40% still applies to values over these limitations. Inter-generational wealth and legacy planning, including asset protection, powers of attorney and probate considerations, remain important and should be addressed in a well-drafted financial plan.

When thinking about these new rules, families can pair gifts with philanthropy by using a Charitable Lead Trust (CLT) as well as making gifts to Irrevocable Trusts and Generation Skipping Trusts.

In terms of charitable donations, gifts of cash to public charities are now deductible up to 60% of adjustable gross income (AGI), rather than at the 50% rate. Since the new rules include limiting the deductions and increasing the standard deduction, many taxpayers will switch from itemizing to taking the standard deduction. This removes the incentive to make annual gifts to charity. One strategy that families can use, and which may increase in popularity, is using a Donor Advised Fund, which can be funded with large gifts up front while delaying the actual distribution to a charity. A donor may contribute to the fund as frequently as he or she wishes and then make a grant to their charity of choice when ready. Taxpayers may even want to create and fund these accounts before the end of 2017.

+ SHORT AND LONG TERM IMPLICATIONS FOR THE ECONOMY

The Tax Cuts and Jobs Act of 2017 will have an impact on consumers and businesses, with short and long-term implications for the economy. Most of the cuts are geared toward individuals – roughly 77% towards individuals and 23% to corporations. For consumers, tax cuts will amount to $100 billion in 2018 and $200 billion in 2019. For corporations, tax cuts will amount to $80 billion per year.

We believe this will stimulate demand rather than supply and thus will push interest rates and inflation up. Initially, the consumer tax cuts will spur consumer spending. On the corporate side, there may not be a huge surge in investment spending, as corporations may potentially use tax savings to pay down debt, conduct M&A or buy back shares.

It is likely that the individual and corporate tax cuts will boost GDP in 2018 and 2019, in addition to lowering the unemployment rate. Interestingly, even without the tax cut, the economy is strong and we would likely have seen 2.5%+ GDP growth per year. With this plan in effect, we believe we will see 3%+ GDP growth and a drop in the unemployment rate may below 3.4% in 2018. This would exert upward pressure on wages and inflation, and lead the Fed to raise rates more often or faster than expected. In addition, it could limit U.S. corporate earnings.

It is important to remember that the long-term growth of the economy is hindered by supply, not demand. We don't have enough workers, and unless we increase immigration or people live longer or work longer, that will stay the same. We expect the long-term impact on productivity to be modest beyond 2019, as GDP should slow, leading to a higher fiscal deficit .

+ IMPLICATIONS FOR INVESTOR PORTFOLIOS

The Tax Cut and Jobs Act of 2017 has implications for investment portfolios that investors need to consider. As mentioned in prior articles in this guide, changes in tax and estate rules will have both short and long-term impact on the U.S. economy, as well as on certain investment asset classes.

A faster growing economy and increase in interest rates suggest that stocks may outperform bonds. Specifically, small cap stocks and high-tax sector stocks like consumer discretionary, financial services and telecom, may outperform low-tax sector stocks. In addition, municipal bonds in higher tax states may see a small positive impact.
In contrast, sectors with low-tax rates like REITS and technology may underperform. The healthcare sector, specifically insurance companies, may be hurt as people will no longer need to be insured.

The Tax Cut and Jobs Act of 2017 will create a different investment environment with new challenges going forward. Now more than ever, there is a need for thoughtful, disciplined investment advice. We believe in diversifying a portfolio across different securities, sectors, and countries. That also means identifying the right mix of investments (stocks, bonds, real estate) that align with investors' risk tolerance. Using this approach, returns from year to year may not match the top performing portfolio, but neither are they likely to match the worst.

We continue to monitor the global economy and seek opportunities to invest in certain sectors and geographic regions given the evolving market environment. In our view, a long-term investment horizon, asset allocation, diversification and discipline remain crucial to portfolio success. If you are a client and would like further detail on these topics or anything else, please don't hesitate to call or email us. If you are not a client, but would like more information on Callan Capital, please visit www.callancapital.com or call (858) 551-3800.

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