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Economic & Market Perspectives

Despite an expectation for solid global profit growth this year, markets remained volatile in the second quarter as geopolitics dominated the headlines. Trade tensions and a stronger dollar took center stage, which led the more domestically focused U.S. small cap sector to a second quarter return of 7.8%, outperforming their large cap peers' 3.4% return.

International equities struggled in the second quarter as data in developed markets remained soft, leading developed equity markets excluding the U.S. to fall -0.8% in the second quarter. Furthermore, a stronger U.S. dollar and protectionist rhetoric led emerg-

ing markets to decline -7.7%, making it the worst performing region of the global equity market in the second quarter.

Turning to fixed income, the Federal Reserve raised the federal funds rate for the second time this year, revised its forecasts for rate hikes this year from three to four and continued to forecast three rate hikes next year. Given this backdrop of steady policy normalization and rising rates, fixed income markets were challenged, as core U.S. fixed income returned -0.2% and global high yield returned -2.2%.

Looking ahead, we expect volatility will persist in global

2018 Returns

<i>S&P 500</i>	2.65%
<i>NASDAQ</i>	10.65%
<i>Russell Small Cap</i>	7.66%
<i>Russell Mid Cap</i>	2.35%
<i>MSCI EAFE</i>	-2.75%
<i>MSCI World</i>	0.43%
<i>Barclay US Agg. Bond</i>	-1.62%
<i>Barclay Municipal Bond</i>	-0.25%

markets. Volatility is normal and should be expected, and our preferred investment approach remains one of balance.

Source: J.P. Morgan Asset Management

What is the Difference Between a Tax Deduction and a Tax Credit?

Tax deductions and credits are terms often used together when talking about taxes. While you probably know that they can lower your tax liability, you might wonder about the difference between the two.

A tax deduction reduces your taxable income, so when you calculate your tax liability, you're doing so against a lower amount. Essentially, your tax obligation is reduced by an amount equal to your deductions multiplied by your marginal tax rate. For example, if you're in the 22% tax bracket and have \$1,000 in tax deductions, your tax liability will be reduced by \$220 ($\$1,000 \times 0.22 = \220). The reduction would be even greater if you are in a higher tax bracket.

A tax credit, on the other hand, is a dollar-for-dollar reduction of your tax liability. Generally, after you've calculated your federal taxable income and determined how much tax you owe, you subtract the amount of any tax credit for which you are eligible from your tax obligation. For example, a \$500 tax credit will reduce your tax liability by \$500, regardless of your tax bracket.

The Tax Cuts and Jobs Act, signed into law late last year, made significant changes to the individual tax landscape, including changes to several tax deductions and credits.

The legislation roughly doubled existing standard deduction amounts and repealed the

deduction for personal exemptions. The higher standard deduction amounts will generally mean that fewer taxpayers will itemize deductions going forward.

The law also made changes to a number of other deductions, such as those for state and local property taxes, home mortgage interest, medical expenses, and charitable contributions.

As for tax credits, the law doubled the child tax credit from \$1,000 to \$2,000 for each qualifying child under the age of 17. In addition, it created a new \$500 nonrefundable credit available for qualifying dependents who are not qualifying children under age 17. The tax law provisions expire after 2025.

The College Landscape After Tax Reform



College students and their parents dodged a major bullet with the Tax Cuts and Jobs Act of 2017. Initial drafts of the bill included the elimination of Coverdell Education Savings Accounts, the Lifetime Learning Credit, and the student loan interest deduction, along with the taxation of tuition waivers, which are used primarily by graduate students and college employees. In the end, none of these provisions made it into the final legislation. But a few other college-related items did. These changes take effect in 2018.

529 plans expanded

The new law expands the definition of 529 plan "qualified education expenses" to include K-12 tuition. Starting in 2018, annual withdrawals of up to \$10,000 per student can be made from a 529 college savings plan for tuition expenses related to enrollment at a K-12 public, private, or religious school (excluding home schooling). Such withdrawals are now tax-free at the federal level.

At the state level, some states automatically update their state 529 legislation to align with federal 529 legislation, but other states will need to take legislative action to include K-12 tuition as a qualified education expense. In addition, 529 plan institutional managers will likely further refine their rules to accommodate the K-12 expansion and communicate these rules to existing account owners. Parents who are interested in making a K-12 contribution or withdrawal should understand their plan's rules and their state's tax rules.

The expansion of 529 plans may impact Coverdell Education Savings Accounts (ESAs). Coverdell ESAs let families save up to \$2,000 per year for a child's

K-12 or college expenses. Up until now, they were the only option for tax-advantaged K-12 savings. But now the use of Coverdell ESAs may decline as parents are likely to prefer the much higher lifetime contribution limits of 529 plans — generally \$350,000 and up — over the \$2,000 annual limit for Coverdell accounts. In addition, Coverdell ESA contributions can only be made for children under age 18.

Coverdell ESAs do have one important advantage over 529 plans, though: investment flexibility. Coverdell owners have a wide variety of options in terms of what investments they hold in their accounts, and may generally change investments as often as they wish. By contrast, 529 account owners can invest only in the investment portfolios offered by the plan, and they can change their existing plan investments only twice per year.

In addition, the new tax law allows 529 account owners to roll over (transfer) funds from a 529 account to an ABLE account without federal tax consequences if certain requirements are met. An ABLE account is a tax-advantaged account that can be used to save for disability-related expenses for individuals who become blind or disabled before age 26. Like 529 plans, ABLE plans allow funds to accumulate tax deferred, and withdrawals are tax-free when used for a qualified expense.



New calculation for kiddie tax

The tax reform law changes the way the "kiddie tax" is calculated. Previously, a child's unearned income over a certain amount was taxed at the parents' rate. Under the new law, a child's unearned income over a certain amount (\$2,100 in 2018) will be taxed using the compressed trust and estate income tax

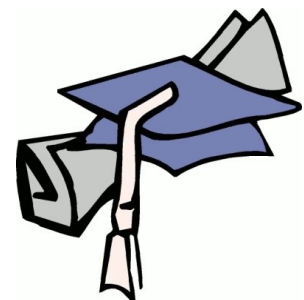
brackets. This change may make the use of UTMA/UGMA custodial accounts less attractive as a college savings vehicle due to the reduced opportunity for tax savings.

There is also a new tax in place on large college endowments

The tax law creates a new 1.4% tax on the net investment income of large college endowments. Specifically, the tax applies to institutions with at least 500 tuition-paying students and endowment assets of \$500,000 or more per student. Approximately 30 colleges are expected to be swept up in this net in 2018, including top-ranked larger universities and smaller elite liberal arts colleges. Some affected colleges have publicly stated that the tax will limit their ability to fund certain programs, including financial aid programs.

Loss of personal exemptions

Starting in 2018, the tax law eliminates personal exemptions, which were \$4,050 in 2017 for each individual claimed on a tax return. So on their 2018 tax returns (which will be completed in 2019), parents of college students will lose an exemption for each college student they claim. However, this loss may be at least partially offset by: (1) a larger standard deduction in 2018 of \$24,000 for joint filers (up from \$12,700 in 2017); \$12,000 for single filers (up from \$6,350 in 2017); and \$18,000 for heads of household (up from \$9,350 in 2017); and (2) a new family tax credit of \$500 in 2018 for each dependent who is not a qualifying child (i.e., under age 17), which would include a dependent college student. The income thresholds to qualify for this credit (and the child tax credit) are significantly higher: up to \$400,000 adjusted gross income for joint filers and up to \$200,000 for all other filers.



What are the Gift and Estate 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, howev-

er. 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.



Marriage and Money: Taking a Team Approach to Retirement

Now that it's fairly common for families to have two wage earners, many husbands and wives are accumulating assets in separate employer-sponsored retirement accounts. In 2018, the maximum employee contribution to a 401(k) or 403(b) plan is \$18,500 (\$24,500 for those age 50 and older), and employers often match contributions up to a set percentage of salary.

But even when most of a married couple's retirement assets reside in different accounts, it's still possible to craft a unified retirement strategy. To make it work, open communication and teamwork are especially important when it comes to saving and investing for retirement.

Retirement for two

Tax-deferred retirement accounts such as 401(k)s, 403(b)s, and IRAs can only be held in one person's name, although a spouse is typically listed as the beneficiary who would automatically inherit the account upon the original owner's death. Taxable investment accounts, on the other hand, may be held jointly.

Owning and managing separate portfolios allows each spouse to choose investments based on his or her individual risk tolerance. Some couples may prefer to maintain a high level of independence for this reason, especially if one spouse is more

comfortable with market volatility than the other.

However, sharing plan information and coordinating investments might help some families build more wealth over time. For example, one spouse's workplace plan may offer a broader selection of investment options, or the offerings in one plan might be somewhat limited. With a joint strategy, both spouses agree on an appropriate asset allocation for their combined savings, and their contributions are invested in a way that takes advantage of each plan's strengths while avoiding any weaknesses.

Asset allocation is a method to help manage investment risk; it does not guarantee a profit or protect against loss.

Spousal IRA opportunity

It can be difficult for a stay-at-home parent who is taking time out of the workforce, or anyone who isn't an active participant in an employer-sponsored plan, to keep his or her retirement savings on track. Fortunately, a working spouse can contribute up to \$5,500 to his or her own IRA and up to \$5,500 more to a spouse's IRA (in 2018), as long as the couple's combined income exceeds both contributions and they file a joint tax return. An additional \$1,000 catch-up contribution

can be made for each spouse who is age 50 or older. All other IRA eligibility rules must be met.

Contributing to the IRA of a nonworking spouse offers married couples a chance to double up on retirement savings and might also provide a larger tax deduction than contributing to a single IRA. For married couples filing jointly, the ability to deduct contributions to the IRA of an active participant in an employer-sponsored plan is phased out if their modified adjusted gross income (MAGI) is between \$101,000 and \$121,000 (in 2018). There are higher phaseout limits when the contribution is being made to the IRA of a nonparticipating spouse: MAGI between \$189,000 and \$199,000 (in 2018).

Thus, some participants in workplace plans who earn too much to deduct an IRA contribution for themselves may be able to make a deductible IRA contribution to the account of a nonparticipating spouse. You can make IRA contributions for the 2018 tax year up until April 15, 2019.

Withdrawals from tax-deferred retirement plans are taxed as ordinary income and may be subject to a 10% federal income tax penalty if withdrawn prior to age 59½, with certain exceptions as outlined by the IRS.

Mid-Year Planning: Tax Changes to Factor In



At Financial Solutions you'll find a fee-only Registered Investment Advisor (RIA) committed to putting your interests and your needs first, eliminating the commissions and self-serving incentives that get in the way of solid, successful financial planning and investment management.

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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 as 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 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 before the return due date.