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"The end result [of the elimination of advisory fees under the TCJA] is that under current law, payments to advisors who are compensated via commissions can be made on a pre-tax basis, but paying advisory fees to advisors are not tax deductible… which is especially awkward and ironic given the current legislative and regulatory push towards more fee-based advice!"

— Michael Kitces, CFP®

Tax and Financial Strategies

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Wealth Creation Strategies

Errata to Issues # 62-64 on the TCJA

The Tax Cuts and Jobs Act (TCJA) is incredibly complex and our interpretations change. Just days after we mailed the first three issues, we discovered new interpretations of and clarifications for a number of items discussed.

First, "**Taxable Income**" on page 3 of issue # 62 of *WCS* (Part I of this series) was defined under the new law as Adjusted Gross Income (AGI) minus either the Standard Deduction or actual itemized deductions. It should have read, "AGI minus the Standard or itemized deductions minus the Qualified Business Income Deduction (QBID)."

Second, on page 6, issue # 62 (Part I) we included a table that described **Qualified Business Income (QBI)** as "net business income" from a sole proprietorship (and, similarly, "net partnership income after guaranteed payments" for a partner in a partnership). A new interpretation suggests that these numbers must be reduced by three business-only adjustments to income: (1) deductible Self-Employment tax, (2) deductible retirement plan contributions, and (3) deductible health insurance premiums. Essentially, this equalizes treatment between sole proprietors, partnerships and S-Corporations, the latter of which already excludes these items from net business income and, therefore, QBI. However, there are still two unrelated unequal treatments: first, wages paid to S-Corporation shareholders are excluded from QBI, which makes S-Corporations less favorable than sole proprietorships or partnerships; second, S-Corporation shareholders don't pay payroll taxes —Social Security and Medicare—on net business income, which can make S-Corporations more favorable.

Third, the **new $500 per dependent "Family Credit"** discussed on page 3 of issue # 63 (Part II) is considered part of the Child Tax Credit and, therefore, will also require us to do "due diligence," including collecting some extra info to ensure your eligibility for the credit. And like the other credits, we can be hit with a $505 inflation-adjusted penalty for disallowance of a credit.

Fourth, the **entertainment expenses for clients or customers** shown on the first two lines of the table on page 4 of issue # 63 (Part II) may be deductible after all. Where business discussions occur in entertainment settings like sporting events and client or customer parties, S-Corporations and C-Corporations *may* be able to take a 50% deduction—but only when an employee pays and is reimbursed for the expense by their employer under an accountable plan. Events like concerts and theater events are not conducive to business discussions and are, therefore, not deductible. Sole proprietors and, probably, partners do not qualify under this possible loophole.

Fifth, the **deduction for the more-than $500,000 business loss for a Joint filer ($250,000 for others)** discussed on page 8 of issue # 63 (Part II) will not be disallowed when there are offsetting wages, because wages are considered business income for this purpose. However, if the $2 million in salary is instead investment income (capital gains and the like), retirement income or other non-business income, the $1,500,000 loss will be disallowed.

Sixth, there may be a way out of the new ultra-high "trust" rates for the tax on **"unearned" income for dependents under age 24**, discussed on page 8 of issue # 63 (Part II): we can choose to tax the income at the parents' rate by including it on the parents' return on a special tax form.

Seventh, we mentioned on page 5 of issue #64 (Part III) that **Ponzi-like and other investment casualty losses** are no longer deductible. This assertion was in error: we now believe they are still deductible, but only for itemizers (and without the 10% plus $100 thresholds). In addition, **casualty losses** in some Presidentially-declared disaster areas (certain hurricanes and wildfires) are subject to a $500 threshold (no 10% plus $100 threshold) and are in addition to the standard deduction. These changes are surprisingly close to the system we recommend for all casualty losses on page 5 of issue # 64 (Part III of this series). They need only expand this treatment to all casualty losses.

Tax Savings Strategies Under the New TCJA

Planning and strategizing will be as profitable as ever under the Tax Cuts and Jobs Act (TCJA). There are new strategies available and old ones with new twists.

Bunching itemized deductions

The idea of "bunching" itemized deductions every few years isn't new—we've employed the strategy for decades. The TCJA will increase the number of taxpayers for whom "bunching" will be profitable—especially Joint filers who regularly make large cash donations to qualified charities.

The TCJA limits the state and local income (or sales) and property tax itemized deductions to $10,000 regardless of filing status. It also increases the standard deduction to $12,000 for Single filers, $18,000 for Heads of Household and $24,000 for Married filers (add $1,300 for each Joint filer and $1,600 for other filers age 65 and over). Single filers whose state income and property taxes are already at or over $10,000 have only $2,000 to go before itemizing and probably don't need to "bunch." Head of Household filers are more likely to find bunching helpful, because they need a minimum of $8,000 of non-tax itemized deductions. For Joint filers, non-tax itemized deductions such as mortgage interest, charity, out-of-pocket medical in excess of 7.5% of 2018 Adjusted Gross Income and a few other rare deductions must exceed $14,000 before they begin to save a dime.

When qualifying mortgage interest and other non-tax deductions are insignificant or non-existent, charitable donations can be used to fill the gap. A Joint filer with the maximum allowed income and property tax deductions and, say, $5,000 of qualifying mortgage interest needs an additional $9,000 in itemized deductions to exceed the $24,000 standard deduction. If they want to itemize, they should donate big if they donate at all.

Those who intend to bunch itemized deductions by donating large sums to charity should consider a "Donor Advised Fund" (DAF) to streamline the process (DAFs are discussed in depth in issue # 61 of *Wealth Creation Strategies*, at www.DougThorburn.com). To maximize tax savings, a donation is made to a Donor Advised Fund once every several years; the DAF donation counts as a charitable deduction in the year made. In subsequent (or "skipped") years, the standard deduction is taken, and donations are made from the DAF, while direct charity and other itemized deductions like property and income/sales taxes are minimized.

Take for example the Joint filer above, with $10,000 in deductible taxes and $5,000 in mortgage interest. They've got ($24,000 - $15,000 =) $9,000 to go before itemizing. Say their "usual" donations to their church (or array of free-market think tanks) total $8,000 yearly, for which they will no longer get a tax benefit. When they use the "bunching" strategy, they could donate $32,000 in year one to a DAF and make their regular $8,000 annual donations from the DAF in years one through four. Assuming they are in the new 22% marginal tax bracket for the full breadth of year-one itemized deductions, they save a whopping $7,040!

The Advantages of "Bunching" Charitable Donations Using DAFs*

Itemized Deductions:	Tax Savings on the Greater of $24,000 Standard Deduction or Actual Itemized Deductions at a 22% Marginal Tax Rate				Total Savings Over Four Years at a 22% Marginal Tax Rate:
	Year 1	Year 2	Year 3	Year 4	
Bunching Strategy: $10K State Income & Property Tax, $5K Mortgage Interest, Plus $32K Charity *Year One Only*	$12,320 (=$47,000 x 22%)**	$5,280 (=$24,000 x 22%)	$5,280 (=$24,000 x 22%)	$5,280 (=$24,000 x 22%)	$28,160
No Strategy: $10K State Income & Property Tax, $5K Mortgage Interest, Plus $8K Charity Each Year	$5,280 (=$24,000 x 22%)	$5,280 (=$24,000 x 22%)	$5,280 (=$24,000 x 22%)	$5,280 (=$24,000 x 22%)	$21,120
Net Federal Tax Savings Using the "Bunching" Itemized Deductions Strategy	$7,040 (=$28,160 - $21,120)***				

* Donations can be made directly, so long as you don't mind giving in one year and then not giving in several subsequent years. Only a DAF allows a deduction when donations are spread out over several years.

** Note that this is the only year of the four when they itemize federal deductions.

*** Depending on the state, there may be additional state income tax savings.

The bunching strategy is especially useful for upper-income earners with Specified Service Businesses (SSBs, discussed in issue # 62 of *WCS*) and taxable incomes above the **Qualified Business Income Deduction**

(**QBID**, also discussed in issue # 62) phase-out, starting at $315,000 ($157,500 for non-joint filers). After doing all they can to reduce net business income using other strategies, they can further reduce taxable income with large ("bunched") charitable donations. Rather than saving at a 24% and/or 32% federal rate (their nominal marginal tax rates at that level of income) for the donations deduction, they could save at a 50% federal rate (their phantom, but very real tax rate due to the phase-out of the QBID). Adding state income tax could increase the savings on a "chunk" of deductions to nearly 64% in sunny California.

IRA holders should make direct charitable transfers once they hit 70½

Direct charitable transfers from IRAs, where donations flow directly from the IRA to the charity by those over age 70½, are a more useful tax reduction strategy than ever due to the near-doubling of the standard deduction. While such transfers are not included in income, reducing not only regular income but also possibly taxable Social Security, they do count towards the annual Required Minimum Distribution (RMD). When Social Security benefits are large enough to be phased in to taxable income, direct charitable transfers can save up to 40.7% (22% plus 85% of 22%) of the amount donated. For a more detailed discussion, see the top stories in issues # 59 and # 43, and page 3 of issue # 27 of *Wealth Creation Strategies* at www.DougThorburn.com. We recommend that everyone with an IRA who's hit age 70½ and who donates money to charity re-read these. *All* cash donations made by those with IRAs who are over age 70½ should be made via direct charitable transfers from IRAs. Unfortunately, direct charitable transfers are not allowed from non-IRA retirement plans; to facilitate this strategy, roll other pre-tax retirement plans into IRAs.

Turn employee business expenses into deductible ones: ask your employer to adopt an "accountable plan"

Two classes of taxpayers can negate the federal elimination of employee business expenses: those who can convince their employer to set up an "accountable plan" for reimbursing expenses, and those who can incorporate, forming their own business. Since incorporating is rarely feasible, we'll focus for now on accountable plans and leave the latter for a future issue.

An "accountable plan" has been a great tax savings tool for both employer and employee ever since employee business expenses were limited to the excess over 2% of Adjusted Gross Income (AGI) and deductible only by those who itemize. Now, with the complete elimination of employee business expenses as a federal itemized deduction, it's a true "no brainer" when feasible.

An accountable plan is simple: it's a formal, written agreement that allows the employer to reimburse the employee for legitimate business expenses the employee incurs, such as business driving, overnight travel costs, continuing education, business supplies, etc. Once a month (we'd be happy with once a year at year-end, especially if the dollars don't amount to much, but tax law technically requires monthly) the employee gives the employer copies of receipts for their expenses (this must include a mileage log for business driving), for which the employee is reimbursed—tax-free—while the employer deducts the expenses on their business return. For employee business driving, either the government-allowed optional mileage rate (54.5 cents per mile in 2018; it changes annually) OR actual expenses times the percent of business use can be reimbursed. In both cases, actual business-only AND total mileage records must be maintained.

Some employers may be reluctant to institute a reimbursement plan, especially for employees who are paid on commission or receive bonuses. There's an easy way around their objections: reduce the compensation by the expected yearly reimbursements and limit the reimbursement to, say, $5,000 (or $20,000, or whatever works) over the course of the year. Any reimbursement left "unspent" could be paid as a fully taxable bonus to the employee at year-end. The agreement could also be structured to allow an employee to request a bonus at any time during the year for the pro-rated amount earned, with the understanding that future reimbursable expenses decrease accordingly.

An accountable plan saves the employee both income and payroll tax on whatever was spent on business expenses. For example, a $10,000 reimbursement for business expenses paid to an employee in the 22% marginal tax bracket can save as much as $3,995 (22% federal + 7.65% employee's half of FICA + 9.3% CA state + 1% CA SDI). And guess who else saves? The employer! To the extent salary is converted to reimbursed expenses, they save payroll taxes and other costs of employment that depend on salary, such as worker's compensation premiums and unemployment "insurance" costs. The employer would save a minimum of $765 (the employer's share of FICA) on the $10,000 reduction in salary. This should incentivize even the most reluctant employer into instituting an accountable plan.

Pay investment advisory and other fees for IRAs from the IRA

Because the TCJA eliminated the itemized deduction for investment expenses, there is no longer a federal tax benefit to paying investment advisory fees for IRA accounts personally. Instead, all such fees should be paid directly from the IRA, decreasing the amount in the account, thereby decreasing future taxable withdrawals. This recommendation does not apply to the strategy of personally paying fees for managing Roth IRA investments; paying personally preserves the balance in the Roth IRA and is tantamount to adding money to the Roth.

Any fees or expenses paid by and incurred for business retirement plans are still deductible by the business.

Do a series of Roth conversions when subject to low marginal tax rates

Roth conversions should be considered by nearly everyone in the 12% (9.6% phantom QBID), 10% (8% QBID) and zero marginal federal tax brackets. This is emphatically true if there are large

amounts in pre-tax retirement accounts or even small amounts for young people who may be subject to much higher rates in retirement (since they have plenty of years to add to pre-tax retirement plans and watch them grow). Carefully implemented conversions over multiple years of low tax rates can create enormous long-term tax savings. But be mindful of state income taxes on conversions, as well as the fact that the TCJA took away the ability to recharacterize ("undo") Roth conversions.

One client commenced a series of Roth conversions in 2005, converting about $250,000 over the following ten years at a total federal and state tax cost of about $22,000—a less-than 9% average tax rate. The Roth has since grown to nearly a half million. Much of her pension and the RMDs from what remains in her traditional IRA (which has also grown) are now taxed at 22.2% and even 40.7% brackets (due to the way Social Security is added to the taxable base). If the converted funds had remained inside her IRA, she (or her heirs) would eventually pay tax of at least ($500,000 x 22.2% =) $111,000, not counting state income tax (likely in the range of $10,000 to $20,000). By paying the tax early, she saved at least $89,000; in viewing the taxes she paid as an "investment," she more than quintupled her money. Other clients who took our advice and did a series of Roth conversions likewise have done exceedingly well. Because rates are (possibly temporarily) low, it may be the perfect time to start your own series of Roth conversions. Email Doug to discuss now, as conversions must be done in 2018 to count for 2018.

Those in higher brackets with little or no state income tax liabilities who expect their income to remain high for the rest of their lives may also benefit by paying tax on Roth conversions while they can at what may prove to be relatively low rates. After all, tax rates could increase under a future Congress.

Reduce or eliminate pre-tax retirement contributions when subject to low marginal tax rates

In the past, I counseled those in the old zero, 10% and 15% marginal tax brackets to add retirement contributions to after-tax accounts, especially Roth IRAs. If the funds were added to pre-tax accounts, the tax rates on future taxable withdrawals could easily exceed the low tax savings on the contribution. Roth IRAs are tax-free when withdrawn (you already paid tax on the contribution, so your principal is returned tax-free, and the growth is tax-free so long as easy-to-follow rules are adhered to). Because the TCJA introduced (15% - 12% = 3%; 3%/15% =) 20% lower tax rates, our advice is applicable to far greater numbers.

Many people, without thinking it through, make pre-tax 401k contributions in zero or low (10% or 15%—now 12%) brackets. While we recommend doing so up to the extent the employer matches part of the contribution, we don't suggest doing this for contributions in low brackets above the point the employer stops matching. When contributions are withdrawn in retirement, even moderate-income retirees can be subjected to new phantom (but very real) 22.2% and even 40.7% marginal tax brackets due to the Social Security phase-in. Worse, certain states tax Social Security, subjecting some moderate-income taxpayers to effective 10%+ state tax rates, creating 50% rates for some moderate-income retirees. The states that tax Social Security are: Colorado, Connecticut, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Rhode Island, Utah, Vermont and West Virginia; each varies in how they implement the tax.

Taxpayers subject to the new lower rates of 12% or less should instead generally contribute to Roth 401ks, especially to the extent employers match contributions, despite the minor disadvantages of such plans (discussed on pages 6-7 of issue # 54 of *Wealth Creation Strategies*). Lower-income taxpayers without access to Roth 401ks should generally contribute to Roth IRAs.

One significant exception to this rule are taxpayers who trigger a Retirement Saver's Credit due to a reduction in AGI resulting from additional traditional IRA or 401k contributions. While triggering the credit with a 401k is difficult to plan for, doing so with an IRA requires a bit of analysis once all the numbers are in. We recommend that those close to a trigger point save their money to make a prior-year Roth or IRA contribution before the April 15th deadline, as we can fine-tune our recommendations to maximize this (and other) credits once we have all your other tax information. This is the reason we generally suggest that you not make IRA contributions during the year; we can't recommend the type of IRA or contribution amount until we've otherwise completed your return.

Other low-income taxpayers who should make pre-tax contributions are those who expect little or no non-Social Security income in retirement. Those with an average life expectancy can ratably withdraw from a (roughly) $250,000 pre-tax retirement account ($450,000 if married) starting at age 70 and pay little or no tax for the rest of their life. Saving 12% (and often more due to the Saver's Credit) during the contribution phase is a terrific deal for those who pay zero tax on withdrawals during retirement. This idea is discussed in depth on pages 5-6 of issue # 53 of *WCS*.

Start a business

The new Qualified Business Income Deduction (QBID) cuts the income tax rate on all Self-Employment (non-wage) and rental income by up to 20%. Not everyone is cut out to be self-employed, however; we've seen countless start-ups that ultimately failed. Being self-employed often means spending many more hours working than employees do, often for less income while in the start-up phase or during periods of business slowdowns. Self-employed people must be excellent not only at one's chosen occupation or profession, but also at marketing, sales, pricing, management and, frequently, multi-tasking, law and insurance (at least to the extent needed to know when an attorney or insurance agent may be required). The Self-Employed don't get the perks employees often get—holiday, vacation and sick pay, employer matching Social Security, employer-paid pensions and medical

insurance, continuing education, etc. And they take risks that employees don't. But there are myriad benefits: having more control, potentially higher income and, now, a potentially lower tax rate on earnings. We expect the QBID will incentivize an increase in entrepreneurial spirit and activities, to the benefit of us all.

Increase the size of a qualifying home office

Under what is now-ancient law, the benefit of deductions for interest and property taxes was generally realized with or without a home office, regardless of its size. Due to the new cap on the income (or sales) and property tax deductions, the new cap on the maximum qualifying debt under the mortgage interest deduction and increased standard deductions, the odds of getting the benefit of itemized deductions for mortgage interest and property taxes are far lower. Anything you can do to create or increase the size of an exclusive-use home office will benefit you—but be prepared to prove its legitimacy. Drawings or floor plans showing the entire home and home office measurements, as well as pictures of the home office are essential. Additionally, you must be careful to never, ever use an otherwise qualifying home office for personal or other disqualifying uses, such as wage-based employment—now a disqualifying use.

A surprising benefit of a home office: property tax and mortgage interest exceeding the new limits for itemizing are deductible to the extent of qualifying use.

Smooth income to reduce taxes

I've discussed the long-term tax saving merits of "income smoothing" for decades, long before the Roth conversion made it easier. The tax savings from realizing $55,000 net business income (or $50,000 of ordinary other income) in each of two years vs. $110,000 (or $100,000 of ordinary other income) in one year and zero in the second is nearly $7,000 for a single filer (lucky Californians can add another more than $3,000 to the cost of such uneven earnings). Earning $121,000 in one year and $81,000 in the other costs $2,000 more tax than $101,000 in each of two years for a Joint filer without dependents or itemized deductions (the last $20,000 is taxed at 22% in the higher-income year; that same $20,000 shifted to the lower income year would have been taxed at 12%).

Real estate brokers are a good example of taxpayers with volatile earnings; retirees without competent counsel who withdraw wildly disparate amounts from their IRAs also demonstrate unnecessary volatility in retirement income (although we've discovered a surprising exception to this due to the way Social Security is taxed—there are frequent exceptions in both tax law ***and*** strategies!). For brokers, retirees and many others volatility is unnecessary, as income can often be "smoothed" from one year to another, decreasing income in higher-income years with deductible contributions and increasing income in lower-income years using Roth conversions.

We can imagine volatile tax situations under the TCJA in which the marginal rate for a Self-Employed person qualifying for the Qualified Business Income Deduction (QBID) is 9.6% on a large swath of income in one year (we think as much as $50,000), while in another it's 22% on an equally large stretch of income. With such disparate rates, it would be profitable to shift some of the income from the second to first year or move some of the deductions from the first to second year. You'd save on whatever can be shifted. While 12.4% doesn't seem like much, converting to the percentage tax savings this becomes a mouth-watering (22%/9.6% =) 129% return on your "investment": what costs $9.60 this year on $100 of net income saves $22, or 129% the following year (or vice-versa).

The $315,000/$157,500 thresholds for the QBID create a new extraordinarily profitable opportunity to use income-smoothing strategies. Take, for example, a couple with $415,000 of taxable income in one year and $215,000 the next. Between the complete loss of the QBID in year one, the smaller QBID (due to lower net income) in the second, and a potentially 8% higher tax rate on $100,000 of income in the higher-income year (32% vs. 24%), the tax cost for having failed to equalize that income to $315,000 in each year could exceed $28,300 over the two-year period. There are several techniques that can be used to reduce and/or smooth taxable income, which apply not only to these higher-income Self-Employed taxpayers, but also to lower- and middle-income taxpayers:

1. Prepay expenses within the confines of what's allowed (usually, an expense that will be incurred within one year of payment),
2. Don't bill customers until after year-end for cash-basis businesses (note: you cannot "hold" checks received prior to year-end, as these constitute current-year income under "constructive receipt" rules),
3. Purchase new or used equipment, including business vehicles (business-use vehicle depreciation deductions have been dramatically accelerated under the TCJA, even if you convert a personal-use vehicle to business use this year),
4. Make pension contributions (and especially, for the more mature, Defined Benefit Pension Plan contributions—these must be set up before year-end), and
5. Because charitable donations reduce taxable income once total itemized deductions exceed the standard deduction, "bunch" charitable donations (most efficiently accomplished via donations to a Donor Advised Fund, discussed above).

High-income earners in tax-favored businesses (non-Specified Service Businesses) can optimize the QBID by paying wages to others, or by incorporating as an S-Corporation and paying a "reasonable" salary to themselves (which may also serve to reduce Social Security and Medicare taxes).

"Smooth" (equalize year-over-year) state and local income and property taxes

If you expect to itemize deductions each year, you should not pay $6,000 of property and state income or sales tax in one year, only to pay $14,000 the next. Because of the new $10,000 yearly limit for such taxes, $4,000 of the $14,000 paid in the second year won't

save a dime of tax. If that last $4,000 is instead paid in the first year (thereby "smoothing" deductions), it could save as much as ($4,000 x 22% =) $880 in tax for a moderate-income taxpayer. Those who continue to itemize should carefully time the payment of property and state income taxes. Remember, what matters is when you make the payment online or mail the bill, *not* when you pay off the credit card or when the recipient cashes the check. Be sure to keep good records and proof of mailing if close to year-end.

Single Filer: Smoothing State Income and Property Tax Deductions

Itemized Deduction:	Bad: without "Smoothing"		Good: with "Smoothing"	
	Year 1	Year 2	Year 1	Year 2
State Income (or Sales) and Property Taxes	$6,000	$14,000 but capped at $10,000	$10,000	$10,000
Mortgage Interest	$8,000	$8,000	$8,000	$8,000
Charitable Donations	$3,000	$3,000	$3,000	$3,000
Total Allowed Itemized Deductions	$17,000	$21,000	$21,000	$21,000
Yearly Tax Savings at a 22% Marginal Tax Rate	$3,740 (=$17,000 x 22%)	$4,620 (=$21,000 x 22%)	$4,620 (=$21,000 x 22%)	$4,620 (=$21,000 x 22%)
Total Tax Savings	$8,360		$9,240	
Overall Tax Savings Using the "Smoothing" Strategy	$880			

"Bunch" both taxes and charitable donations

If your yearly average of state income or sales plus property taxes is, say, $6,000 and you don't itemize except in years in which charitable donations are "bunched," you will benefit by also bunching property and state income or sales taxes in the same year you bunch charity. An example best illustrates this.

Single Filer "Bunching" Charity and Taxes Every Few Years

Itemized Deduction:	Bad: No Strategy	Good: Bunching Deductions Strategy		
	Years 1, 2 & 3	Year 1	Year 2	Year 3
State Income (or Sales) & Property Taxes	$6,000	$6,000	$2,500*	$9.500*
Charitable Donations	$3,000	$0	$0	$9,000
Total Itemized Deductions	$9,000	$6,000	$2,500	$18,500
Standard Deduction	$12,000	$12,000	$12,000	$12,000
Tax Savings on Greater of Itemized or Standard Deduction at the 22% Marginal Tax Rate	$2,640 (=$12,000 x 22%)	$2,640 (=$12,000 x 22%)	$2,640 (=$12,000 x 22%)	$4,070 (=$18,500 x 22%)
Total Tax Savings	$7,920	$9,350		
Overall Tax Savings Using the Bunching Strategy	$1,430			

* This requires some discretion over how much state income and property taxes to pay each year. For example, you may underpay state income tax at the risk of minor under-estimated tax penalties. Property owners in many states, including California, can pay one half of property tax in one year and three halves in the following year.

Towards a More Rational Tax System

Taxation of incomes reduces production, decreasing the amount of goods and services available for consumption and, therefore, living standards. If our goal is maximum consumption and wealth creation, any system taxing income is counter-productive (and I think insane). For the past 50 years, I have thought it arrogant to suggest someone else can tell you how to live your life and spend and invest your earnings better than you can—or tell you they have the right to live at your expense. That said, eliminating the income tax in the U.S. is a pipe dream (even if a consumption tax or a flat tax would result in far greater economic growth). But that doesn't mean we can't dream up a viable, more rational graduated tax system to replace what we have, which might do less damage to wealth creation. It would:

1. Allow deductions for any expenses incurred to produce income, including employee business expenses and investment expenses, as well as for taxes imposed by underlying entities such as state income and property taxes. They would all be deductible in addition to a "standard" deduction.
2. Allow a dollar for dollar tax credit for cash donations to 501(c)(3) organizations (private tax-exempt organizations designed to improve general welfare). In the alternative, at least allow unlimited deductions for such donations in addition to a "standard" deduction.
3. Because medical costs are artificially and absurdly high ("artificial" due to government control, regulations and disincentives to conserve scarce medical resources), make medical costs fully deductible via an expansion of Health Savings Accounts (HSAs). Allow HSAs to be funded to the extent of current medical expenses plus an extra $10,000 per year (with increased "catch-up" provisions, as there are for IRAs and 401ks, for the more mature to help defray increased costs). This plan would also allow others to fund and deduct HSAs for those who can't afford to do so themselves. Employers could make contributions for their employees tax-free as part of their compensation. All medical expenses (except for catastrophic events) would be paid via the HSA; along with other free market innovations, this would cause prices to plummet as taxpayers shopped for the best values. The HSA-like aspects of Singapore's system could be a model for ours. They spend about 4% of Gross Domestic Product on health care; we spend roughly 18%. (Theirs is by no means a libertarian system, but obviously they are doing something right.)

   True medical insurance would cover only catastrophic events like heart attacks and cancer. The rest would be paid out of pocket, just as car insurance covers only accidents and not oil changes or even major repairs due to obsolescence; these are simply part of owning a car and certainly not "unexpected." This is what true insurance is all about—insurance covers the unexpected (like fires), not the expected (like repairing or even replacing a 50-year-old roof).
4. Eliminate all phase-outs of credits and deductions and eliminate all phase-ins of income (Social Security "benefits" in particular). Equality under the law requires that the more productive among us be treated the same—tax law should not reduce or eliminate benefits for higher-income individuals. Why should someone who has done well, whether by pleasing consumers or just dumb luck, lose credits or deductions, or be taxed on something that someone else isn't taxed on? Especially, eliminate the Qualified Business Income Deduction phase-out, which will subject many entrepreneurs to a higher-than 50% marginal tax bracket. Once they figure out their extra work will be penalized at exorbitant rates, many of our best producers will simply work less, resulting in lower availability of and consequentially higher prices for the services of "non-favored" higher-income businesses.
5. Eliminate all double taxation, especially the 35% of Social Security "benefits" that were already taxed when paid by an employee or as Self-Employment tax. Eliminate estate and inheritance taxes, which frequently tax earnings twice and serve to discourage the creation of wealth, encourage extravagant consumption (the government gets half of what you don't squander) and lead to the sale of family businesses to large corporate interests in order to pay estate taxes due on death (reducing competition by family businesses, which provide essential competition to publicly-held companies and incentivize large corporations to be more responsive to consumer needs). Also eliminate either the corporate income tax or the tax on dividends and capital gains. To maximize capital, we would prefer eliminating the corporate income tax and taxing inflation-adjusted capital gains at the individual level.

W-4s and Your Withholding

The TCJA created a mess in its revamp of the W-4, which was originally designed with a "personal exemption" or its equivalent in mind. You would generally claim one exemption, or "withholding allowance," for yourself, one for a nonworking spouse and one for each dependent. Itemizers could claim an extra withholding allowance for every $4,150 (the inflation-adjusted personal exemption amount) of itemized deductions in excess of the standard deduction. If your spouse also worked, each might have to claim fewer withholding allowances to ensure you were not under withheld. Non-wage income also confused things, but we could usually correct for this by further decreasing allowances, claiming "Married, but withhold at the higher Single rate," asking the employer to withhold additional amounts from each paycheck, or by paying quarterly estimates—even if it took a detailed, four-page, small print article written for the *Taxation for Accountants* by yours truly in 1991 to adequately explain withholding

to other tax professionals.

The TCJA eliminated the personal exemption and left it up to the IRS to redo the W-4. The IRS created a new form with 4 pages of instructions and four detailed worksheets, one of which isn't even in the W-4 (you'll find it in a separate IRS publication). Amazingly, every itemizing two-income family with kids should theoretically complete all four worksheets to figure out their withholding allowances.

In lieu of the mental calculus involved in figuring this by hand, an online calculator purports to simplify things, but not even Kristin could figure out how to get the "right" answer when she tested it. One taxpayer tried it and learned she could claim 84 allowances. Right. The IRS has admitted their online calculator is woefully deficient when there are multiple jobs and/ or non-wage income.

And good luck with credits on the new W-4. The value of each credit, like the American Opportunity (tuition) Credit (AOC), must be converted from an expected dollar amount into a numerical withholding allowance based on estimated full-year credit amount and income. Depending on your predicted marginal tax bracket, the exemption-allowance value of the $2,000 Child Tax Credit could be zero, one, two or four; the value of the new $500 "Family Credit" could be a fraction of one (which the W-4 doesn't allow, creating over-withholding). If the tuition credit is the maximum allowed under the AOC, $2,500, allowances could be as low as 2.75 (not allowed) or as many as five. After four confusing tables you arrive at an exemption number for line 5 of Form W-4—but because credits phase in and out as income increases or decreases, the correct figure may change markedly as expected income changes even slightly (several credits phase out over a mere $10,000 or $20,000 of income).

More accurate withholding would be possible if the tables were adjusted to assume that each withholding allowance is worth $2,000, or even $1,000, rather than the old exemption amount, deemed to be $4,150 for 2018. However, you'd still need to know your marginal tax bracket and go through all these other gyrations. Worse, many people have trouble understanding that "marginal tax rate" means "the percentage tax on the additional dollar of income or deduction," which can be tricky even for the knowledgeable when straddling marginal tax brackets.

The W-4 is in serious need of a redesign. The best and easiest fix would have taxpayers determine their expected tax for the year, divide by taxable wages and allow flat percentage withholding. Take a Joint filer with no dependents using the standard deduction: one spouse has taxable (after 401k) wages of $80,000, the other has taxable wages of $50,000 and there is $10,000 of other ordinary income expected, for a total income of $140,000. The tax will be $17,400 on the $140,000, which is 13.4% of gross combined wages of $130,000. If each spouse withholds at 14%, there's a bit of room for error and if they predicted accurately, they will be due a small refund at year-end. The beauty of such an approach is it accounts for multiple W-2 payers (which usually leads to under withholding because each payer treats the income they pay as the "sole" source of income for the year and withholds accordingly) and any kind of ordinary income. Adjustments could easily be made for tax-favored long-term capital gains or qualifying dividends (without an adjustment you would over withhold) and for Self-Employment (without an adjustment you would under withhold). Allowable subtractions from Adjusted Gross Income and the new Qualified Business Income Deduction could be adjusted for, too.

To see this in action, our clients can pull the cover letter sent with their 2017 tax return and find, a few pages back, the "Tax Reform Impact Summary;" this gives the 2018 tax based on 2017 income and deduction figures. If you expect few changes from 2017 to 2018, the tax shown at the bottom of the right-hand column is what should be withheld for 2018. If your income will vary from 2017, most taxpayers (but not all) can add or subtract expected income changes for 2018 or 2019 from the taxable income shown: simply increase or decrease the tax by 22% for any expected increase or decrease in income to the extent that figure stays at more than $78,000 for Joint filers, $39,000 for single filers and $52,000 for Head of Household filers. Increase or decrease the tax by 12% for any expected changes below that figure. Care must be exercised for those with tax credits that may change: the Child Tax Credit of $2,000 per child is lost in the year a dependent turns 17 (replace it with the Family Credit, worth only $500 per dependent), and the American Opportunity Credit (or Lifetime Learning Credit) may change markedly from year-to-year, depending on higher-education tuition paid (and the cost of classroom-required books and supplies for the AOC), as well as income levels. Care must also be exercised for those who started receiving Social Security in or after 2017, since such "benefits" can create nasty phantom tax rates (22.2% for those in the 12% nominal bracket and 40.7% for those in the 22% nominal bracket) as other income increases. This is true, as well, for self-employed people with taxable incomes exceeding $315,000 for Joint filers ($157,500 for others), at which point the marginal tax rate increases from 24% to 32% and the QBID starts to phase out.

For 2019, an easy way to calculate withholding would be to withhold one-twelfth of the total forecasted full-year tax per month, with appropriate adjustments for bi-monthly, bi-weekly or weekly withholding; work backwards into the W-4 by claiming the number of exemptions required (line 5 of Form W-4) and/or "additional amounts" that "you want withheld from each paycheck" (line 6 of Form W-4) to get to the tax withholding needed for the year.

You may see a smaller federal refund in 2019 (for tax year 2018) than in prior years—but likely because you got larger net paychecks during the year than you should have. When trying to determine if you are a "winner" or "loser" under the TCJA, your actual tax refund—the difference between the amount withheld and paid during the year and the actual tax—won't tell you if you won or lost. You must instead compare total tax paid in 2017 with the total tax paid in 2018, assuming income, deductions and credits are the same.