Financial focus

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In This Issue

Tax Reform: Will Your Taxes Go Up or Down?

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The Tax Cut and Jobs Act (TCJA), which was passed by Congress at the end of 2017, has certainly been a popular topic of discussion lately. Everyone wants to know if they will see a reduction in taxes, or if in fact their taxes will go up. The short answer is: It depends!

TCJA includes many changes to the tax code, some of which may impact you positively, some negatively, according to your individual situation. Here are some tips to consider, to help you determine how the changes may impact your tax liability. Remember that these changes will affect the filing of your 2018 tax returns, which will be due in April 2019, not your 2017 taxes, to which the previous tax code still applies.

Here are some things to consider doing in 2018 to avoid a tax surprise in 2019:

1. Get a preview of your 2018 taxes
Ask your accountant to run a mock 2018 return after the 2017 tax returns have been finished. Take a look at the numbers: are there any potential issues that should be dealt with and planned for? Previewing your 2018 tax return can help prevent any unpleasant surprises when it comes time to file the return in 2019.

2. Revisit your withholdings
The new tax law means that the W-4 you filled out many years ago may need to be adjusted. The IRS came out with new withholding tables on January 11, 2018, that reflect changes such as the elimination of personal exemptions in the new tax law. However, the IRS has not yet released an updated withholding calculator or a revised W-4 form.

If you leave your W-4 as is, you could wind up withholding too little, creating an unpleasant tax surprise in 2019! Workers in higher tax brackets who receive large bonuses could see a higher tax bill next year if they don't adjust W-4 withholdings.

3. Watch for State and Local Income Tax (SALT) workarounds
A big change that could affect many taxpayers is the controversial cap on state and local income tax (SALT) and real estate tax deductions. These itemized deductions, which used to be unlimited, will be capped at $10,000 for 2018 returns, for SALT and real estate taxes combined. The new law's increase of the standard deduction to $12,000 for single filers and $24,000 for married couples filing jointly likely means fewer taxpayers will itemize; the cap on SALT and real estate tax deductions could result in residents of high-tax, high-income states owing larger tax bills because of the lost deductions.

For example, California is currently attempting to structure a workaround to keep state residents from seeing a big spike in federal taxes for 2018 and thereafter. Strategies being explored include plans to replace a state income tax with an employer-side payroll tax or a system of tax credits for charitable donations made to state funds that support areas such as education and health care. It's not clear yet whether these attempts will be effective, especially given that the Trump administration has pledged to fight such efforts.

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Smart Car Buying Strategies

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Aside from a home, purchasing a vehicle will likely be your single largest expenditure, so it merits some serious consideration and in-depth research. The buying decision should consider cost of ownership, practicality, safety, and reliability. Unlike your home which appreciates in value over time, a vehicle is a very expensive depreciating asset.

First, how much car can you afford? In general, your spending on vehicle expenses should not exceed 20% of your take-home pay. This includes car payments, gas, insurance, and maintenance. Second, 20% is a maximum, so how much of your total spending do you want locked up in your car costs? The amount you want to tie up in car payments, etc. will vary for each person depending on their unique financial situation and values. For everyone, though, the less you spend on a car, the more money you have for everything else.

Ideally, you could purchase a used car that is about two to three years old with cash. The car will be greatly depreciated, and you get a relatively new car for much less than a brand new car. If paying cash is unrealistic, work with your bank or credit union to get pre-approved for a loan. Most of us must start with a car payment to have reliable transportation to work. One long-term strategy is to pay off the car loan as quickly as possible. Once the loan is paid off, continue making the car payment directly to your savings account. This technique will allow you to build up a larger down payment as you buy successive cars. Eventually, you will always pay cash, using the accumulated savings in your auto replacement fund. Paying cash can save you thousands of dollars in auto loan interest over the years.

The annual April auto issue of Consumer Reports magazine is a good place to start gathering information about the most and least reliable cars in whatever style you desire. If your heart is set on a new sports car or luxury car, consider buying an older model, used vehicle. Cars are often considered status symbols but there are plenty of less expensive ways to express your style and status.

Decide how much you want to spend and make a list of your must-have features. Conduct some on-line research; most dealers now list their inventories of used cars on their websites. Spend a day visiting dealers to test drive your top choices; just make sure you make it clear to the salesperson that you are comparison shopping and will not be making a purchase that day.

The following websites can provide price quotes and information on the new or used cars you are interested in: Edmunds.com, Truecar.com, KBB.com (Kelly Blue Book) and NADA.com. Once you have settled on a couple of options, do some further research to find the invoice price for a new car. Generally, the dealer's actual cost is the invoice price, less about 3% to 5% for factory hold backs, not the MSRP (Manufacturer's Suggested Retail Price) on the car window.

Now you're ready to negotiate the purchase of your car. Get quotes from several dealers and make it clear that you want to focus on the total cost to buy the vehicle, hopefully with cash. Don't let them sidetrack the conversation with discussions about monthly payments, trade-in deals, and financing options where it is harder to decipher the true cost of the vehicle. If purchasing a new car, inform the salesperson that you have done your homework and you have a good idea of what the dealer paid for the car. Let them know you have quotes from other dealers and you are ready to buy a car for their cost (not the MSRP) plus a reasonable profit. Asking for a quote online from several dealers at once via email can be an effective tactic. You are also likely to get a better deal near the end of the month when salespersons are trying to meet their quotas.

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Tax Reform: Will Your Taxes Go Up or Down? (Cont.)

4. Bunch up your donations
For those who itemize, charitable donations remain deductible on federal returns and can help taxpayers exceed the increased standard deduction hurdle. One strategy for those who regularly donate to charity is to bunch up donations into one year what they would typically have given over multiple years. For example, by putting a few years' worth of donations into a Donor Advised Fund (DAF), you can take the itemized deduction the year you put the money in and then distribute the money to charity over multiple years.

5. Home equity loan deductions
The deductibility of interest on home equity loans and lines of credit (HELOCs) has been a big source of confusion. The new tax law lowered the amount on which interest expense on "acquisition indebtedness" could be deducted — from $1 million to $750,000 for new loans made after December 14, 2017. It also eliminated the interest deduction on loans that are not used to 'buy, build, or substantially improve' a home.

Going forward, if you take out a HELOC and use some of the money to buy a car, or pay off credit cards, you cannot deduct that interest. However, if you use the money to fix up your house, that may still be deductible.

6. Expanded college savings plan uses
The new tax law expands the allowable use of tax-exempt 529 college savings plans for education costs that accrue while a child is between kindergarten and high school graduation. However, make sure that your state also accepts paying for pre-college expenses as a qualified distribution; some states may still consider such a withdrawal a non-qualified distribution and charge penalties.

Differences Between Conventional and FHA Mortgage Loans

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The Federal Housing Administration (FHA) is a federal government agency within the U.S. Department of Housing and Urban Development that backs mortgages by providing mortgage insurance on loans made by FHA-approved lenders through the United States. By contrast, a conventional mortgage loan issued through a private entity such as a bank is not guaranteed, or insured, by the federal government. There are several considerations to keep in mind when deciding between a conventional or FHA mortgage loan for your home purchase.

Financial Components
An FHA loan allows for a down payment as low as 3.5%, depending on your credit score, and permits friends and relatives to gift the homebuyer the full amount for the down payment, whereas conventional mortgages typically do not. The debt-to-income ratio for the borrower is also more lenient for an FHA loan. Therefore, if cash flow is tight or your credit score is not ideal, an FHA loan may be best for you. However, the maximum loan for a conventional mortgage is typically higher than for an FHA loan; the value of the home you are purchasing will play a role in determining which mortgage type makes the most sense for you.

If your credit score is good, you have low debt-to-income ratio, and you can make a down payment of at least 5%, you should consider a conventional mortgage. With a conventional mortgage, generally you can avoid the mortgage insurance that is required for an FHA loan. Even if you are required to start out with mortgage insurance on a conventional mortgage, it can be eliminated once you have built 20% equity in your home. Conversely, mortgage insurance premiums continue through the life of an FHA loan. Monthly payments through a conventional mortgage thus will likely be less than they would be with an FHA loan for a comparable loan amount.

Other Considerations
To apply for an FHA loan, you must plan to occupy the home. Only a conventional mortgage can be used to purchase an investment property.

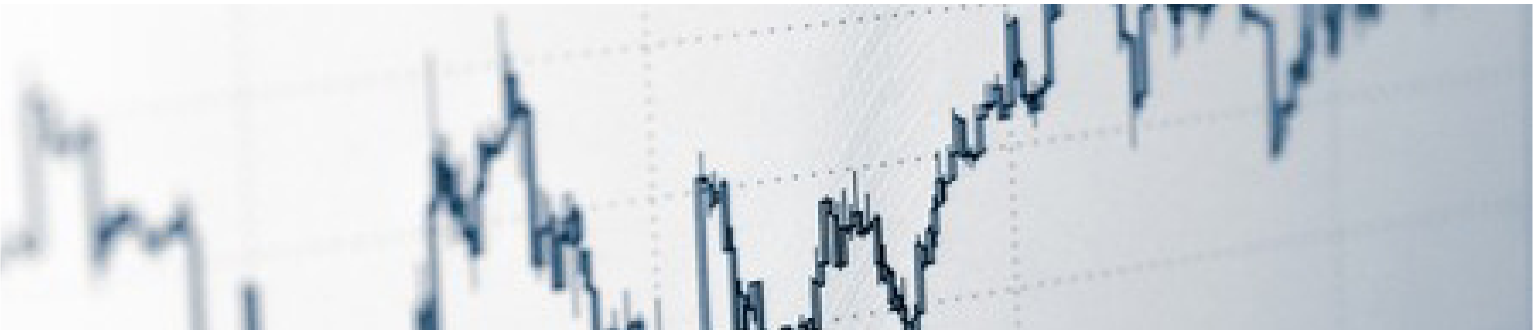
Future changes to your mortgage are simpler with FHA loans than with conventional mortgages. FHA loans are assumable, which means a new buyer can assume your current FHA loan should you choose to sell the home down the road. Refinancing an FHA loan under lower-interest-rate environments is typically easier than it is with a conventional mortgage, because credit checks, reappraisals, and income verifications are not required.

The Bottom Line
If you can qualify, a conventional mortgage is likely your best option, as it is less costly over the term of the loan. Conventional mortgages typically make sense for those who are more financially independent. Always discuss your options with your financial planner and thoroughly consider the pros and the cons of each side.

Smart Car Buying Strategies (Cont.)

When buying a used car, you can probably get a better deal through a private seller than with a dealer, but it will require more work on your part. If buying from a private party, before signing the papers, get a vehicle history report form Carfax.com or Autocheck.com using the vehicles VIN number, and have the car inspected by a good mechanic. Walk away if the owner is unwilling to let you have the car inspected by a mechanic.

For most of us, mortgage payments, car payments, and student loan payments are the biggest determinants of how much we have left to spend on everything else. Time spent researching your next car purchase can pay big dividends.



The Lake Wobegon Effect on Investors

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Garrison Keillor introduced us to the mythical town of Lake Wobegon, Minnesota, a place "where all the women are strong, all the men are good looking, and all of the children are above average." It may be that not all women and men are like those in Lake Wobegon, but certainly all of our children are above average. Undoubtedly those Lake Wobegonians also consider themselves above average in other areas, like driving. In fact, when asked, almost everyone says that they are "above average" drivers, and many suspect that they are above average in a host of other pursuits. The rub is in proving these claims, and that is very hard indeed.

In Poor Richard's Almanac, Ben Franklin once said, "There are three things extremely hard: steel, a diamond, and to know one's self." How we assess ourselves affects virtually every decision we make, yet we routinely make faulty assessments of our abilities. One study found that 70% of high school seniors think they have above average leadership skills. College professors also think highly of their abilities as another study found that 94% freely admitted that they did above average work when compared to peers. Nor are lawyers immune to the "Lake Wobegon" effect as they often overestimate their ability to win the cases they are about to take to trial. And numerous studies have shown that stock pickers think that the stocks they buy will more likely be winners than those bought by the "average" investor.

All of us like to think of ourselves as just a little bit savvier than the average Joe, especially when it comes to our investing prowess. This idea may be reinforced from time to time during periods of rising markets when everyone's portfolio is going up in value. No doubt many of us have confused this phenomenon with investing acumen. As investors we also get duped from time to time by the concept of "recency." This is the mistaken belief that recent conditions will continue into the future. (Home prices always go up . . . don't they?) This "recency effect" accounts for so many folks investing at the tops of markets and selling at or near the bottoms. The US stock market has produced an annual average return of nearly 10% over the past fifty years. It may do better or worse in the future, but history shows that many investors will likely do worse than the average simply because they will trade too often, ignore expenses, and not have a consistent investment policy to guide them.

I believe investing wisdom begins when we acknowledge what we do not know. I now realize that I do not know where the market will be in a month, or a year. I do not know what stock or bond, or ten stocks or bonds to buy to insure my investing success. There may be some with the skill sets or foresight to make such individual stock and bond picks, but the vast majority of us do not have that aptitude, nor will we devote the time necessary to acquire it. I am also aware that there is much that the investment "experts" do not know. I know that sometimes less than 15% of all mutual fund managers will beat their market benchmarks in any particular year, and the ones that do so this year may well fail to do so next year; and these are men and women who devote their lifelong careers to investing and are paid handsomely for doing so.

Once we acknowledge our limitations, and the fact that most experts fare little better, index mutual funds and Exchange Traded Funds (ETFs) begin to look like much wiser investments for most of us. These are "passive" investments (as opposed to "actively managed") with very low expenses. With these low-cost investment options, one can easily construct a well-diversified portfolio. This approach is recommended by many successful investment experts, and specifically by one of my investing heroes, John Bogle of Vanguard fame. Experience has shown that the "average" investor is more likely to find long-term investment success by using low cost investment vehicles like these and a routine investment program where costs are reduced through dollar-cost averaging. With such a program in place, the "average" investor may actually realize "above average" returns compared to his peers. The path to this discovery for many has been littered with frustration and lost opportunities, not to mention lost dollars!

Remember, money is certainly not the most important thing, but still, money matters!