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Your Source for Financial Well-Being

Mid-Year Planning: Tax Changes to Factor In

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The overall limit on itemized deductions that applied to higher-income taxpayers is repealed, the income threshold for deducting medical expenses is reduced for 2018, and the income limitations on charitable deductions are eased.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 has 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 the 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 by the return due date.

3rd Quarter 2018

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Going Public: An IPO's Market Debut May Not Live Up to the Hype

The IPO process is important to the financial markets because it helps fuel the growth of young companies and adds new stocks to the pool of potential investment opportunities.

An initial public offering (IPO) is the first public sale of stock by a private company. Companies tend to schedule IPOs when investors are feeling good about their financial prospects and are more inclined to take on the risk associated with a new venture.

Thus, IPOs tend to reflect broader economic and market trends. And not surprisingly, 2017 was the busiest year for the global IPO market since 2007.[1]

Company insiders who have been waiting for the opportunity to cash out may have the most to gain from an IPO. The higher the price set on IPO shares, the more money the company and its executives, employees, and early investors stand to make.

Nevertheless, the IPO process is important to the financial markets because it helps fuel the growth of young companies and adds new stocks to the pool of potential investment opportunities.

IPO market trends

Newer, smaller companies have traditionally used IPOs to raise capital for expansion. However, some companies are relying on private capital to fund their early growth and development, so they can wait longer to test public markets. These companies often become larger, more mature, and more valuable before they are publicly traded.

This trend may help explain why the amount of money raised through IPOs has increased over the past decade, even as the number of new IPOs has waned. From 2007 to 2016, the number of corporate IPOs averaged 164 per year, down 47% from the previous decade. But average annual IPO proceeds rose 82% over the same period to $284 million.[2]

A privately held company with an estimated value of $1 billion or more is often called a "unicorn," and it's estimated that there are now more than 200 of them in the technology sector alone.[3]

Since the term was first coined in late 2013, unicorns have received most of the media's attention, even though they still make up a relatively small part of the IPO market. The proceeds of 18 unicorn IPOs accounted for 5% of the capital raised from 2014 through 2016.[4]

Pop or fizzle

When IPO share prices shoot up on the first day of exchange trading, it's referred to as a "pop." A significant first-day gain may suggest that investor demand for the company's shares was underestimated. Of course, this doesn't mean that the company will outperform its peers in the long run.

One catch is that it is often difficult to obtain "allocated" stock. Investors who don't have the opportunity to buy shares at the offering price — the price at which insiders are selling to the market — can buy the stock after it starts trading on the exchange. However, much of an IPO's pop can take place between its pricing and the first stock trade. This means investors who buy shares after trading starts often miss out on a large part of the appreciation.

Investors who buy IPO shares on the first day might even pay inflated prices because that's when media coverage, public interest, and demand for the stock may be greatest. Share prices often drop in the weeks following a large first-day gain as the excitement dies down and fundamental performance measures such as revenues and profits take center stage.

Back to reality

A young company may have a limited track record, and an established one may have to disclose more information to investors after it becomes publicly traded. If you're interested in the stock of a newly public company, you should have a relatively high risk tolerance because shares can be especially volatile in the first few months after an IPO. You might even consider waiting until you can evaluate at least two quarters of earnings.

The return and principal value of all stocks fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost. Investments offering the potential for higher rates of return also involve a higher degree of risk.

[1, 4] EY, 2017

[2-3] Bloomberg.com, September 11, 2017

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Protect Your Heirs by Naming a Trust as IRA Beneficiary

While trusts offer numerous advantages, they incur up-front costs and often have ongoing administrative fees. The use of trusts involves a complex web of tax rules and regulations. You should consider the counsel of an experienced estate planning professional and your legal and tax advisers before implementing such strategies.

Often, tax-qualified retirement accounts such as IRAs make up a significant part of one's estate. Naming beneficiaries of an IRA can be an important part of an estate plan. One option is designating a trust as the IRA beneficiary.

Caution: *This discussion applies to traditional IRAs, not to Roth IRAs. Special considerations apply to beneficiary designations for Roth IRAs.*

Why use a trust?

Here are the most common reasons for designating a trust as an IRA beneficiary:

- Generally, inherited IRAs are not protected from the IRA beneficiary's creditors. However, IRA funds left to a properly drafted trust may offer considerable protection against the creditors of trust beneficiaries.
- When you designate one or more individuals as beneficiary of your IRA, those beneficiaries are generally free to do whatever they want with the inherited IRA funds, after your death. But if you set up a trust for the benefit of your intended beneficiaries and name that trust as beneficiary of your IRA, you can retain some control over the funds after your death. Your intended beneficiaries will receive distributions according to your wishes as spelled out in the trust document.
- Through use of a trust as IRA beneficiary, you may "stretch" IRA payments over the lifetimes of more than one generation of beneficiaries. Payments to IRA trust beneficiaries must comply with distribution rules depending on the type of IRA plan.

What is a trust?

A trust is a legal entity that you can set up and use to hold property for the benefit of one or more individuals (the trust beneficiaries). Every trust has one or more trustees charged with the responsibility of managing the trust property and distributing trust income and/or principal to the trust beneficiaries according to the terms of the trust agreement. If the trust meets certain requirements, the beneficiaries of the trust can be treated as the designated beneficiaries of your IRA for purposes of calculating the distributions that must be taken following your death.

Special rules apply to trusts as IRA beneficiaries

Certain special requirements must be met in order for an underlying beneficiary of a trust to qualify as a designated beneficiary of an IRA. The beneficiaries of a trust can be designated beneficiaries under the IRS distribution rules only if the following four trust requirements are met in a timely manner:

- The trust beneficiaries must be individuals clearly identifiable from the trust document as designated beneficiaries as of September 30 following the year of the IRA owner's death.
- The trust must be valid under state law. A trust that would be valid under state law, except for the fact that the trust lacks a trust "corpus" or principal, will qualify.
- The trust must be irrevocable, or by its terms become irrevocable upon the death of the IRA owner.
- The trust document, all amendments, and the list of trust beneficiaries must be provided to the IRA custodian or plan administrator by October 31 following the year of the IRA owner's death. An exception to this rule arises when the sole trust beneficiary is the IRA owner's surviving spouse who is 10 years younger than the IRA owner, and the IRA owner wants to base lifetime required minimum distributions (RMDs) on joint and survivor life expectancy. In this case, trust documentation should be provided before lifetime RMDs begin.

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

Disadvantages of naming a trust as IRA beneficiary

If you name your surviving spouse as the trust beneficiary of your IRA rather than naming your spouse as a direct beneficiary, certain post-death options that would otherwise be available to your spouse may be limited or unavailable. Naming your spouse as primary beneficiary of your IRA provides greater options and maximum flexibility in terms of post-death distribution planning.

Setting up a trust can be expensive, and maintaining it from year to year can be burdensome and complicated. So the cost of establishing the trust and the effort involved in properly administering the trust should be weighed against the perceived advantages of using a trust as an IRA beneficiary. In addition, if the trust is not properly drafted, you may be treated as if you died without a designated beneficiary for your IRA. That would likely shorten the payout period for required post-death distributions.

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What are the gift and estate tax 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, however. 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.

What is gross domestic product, and why is it important to investors?

GDP, or gross domestic product, measures the value of goods and services produced by a nation's economy less the value of goods and services used in production. In essence, GDP is a broad measure of the nation's overall economic activity and serves as a gauge of the country's economic health. Countries with the largest GDP are the United States, China, Japan, Germany, and the United Kingdom.

GDP generally provides economic information on a quarterly basis and is calculated for most of the world's countries, allowing for comparisons among various economies. Important information that can be gleaned from GDP includes:

- A measure of the prices paid for goods and services purchased by, or on behalf of, consumers (personal consumption expenditures), including durable goods (such as cars and appliances), nondurable goods (food and clothing), and services (transportation, education, and banking)
- Personal (pre-tax) and disposable (after-tax) income and personal savings
- Residential (purchases of private housing) and nonresidential investment (purchases of both nonresidential structures and business equipment and software, as well as changes in inventories)
- Net exports (the sum of exports less imports)
- Government spending on goods and services

GDP can offer valuable information to investors, including whether the economy is expanding or contracting, trends in consumer spending, the status of residential and business investing, and whether prices for goods and services are rising or falling. A strong economy is usually good for corporations and their profits, which may boost stock prices. Increasing prices for goods and services may indicate advancing inflation, which can impact bond prices and yields. In short, GDP provides a snapshot of the strength of the economy over a specific period and can play a role when making financial decisions. All investing involves risk, including the possible loss of principal, and there is no guarantee that any investment strategy will be successful.