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U.S. Tax Reform

FINANCIAL PLANNING IMPLICATIONS OF THE U.S. TAX REFORM MEASURE

KEY POINTS

- The U.S. tax reform measure will have wide-reaching effects on investors. We believe a planning strategy based on fundamental principles is the best response.
- While the biggest changes in the tax measure relate to business taxation, individual tax rates are also reduced. Those individual changes will revert to 2017 levels after eight years unless Congress takes further action.
- Considering the temporarily lower rates and future uncertainty, investors may want to consider contributing to Roth accounts.
- Lower taxes may help people to boost their retirement savings to the 15% or more of current salary (including employer matches) that we typically recommend.
- Given the complexities and uncertainties associated with the new tax measure, we strongly recommend that investors consult with their professional tax advisors.

The U.S. tax reform measure could have wide-reaching effects on financial planning decisions for millions of Americans. We believe that a strategy based on fundamental planning principles offers the best path to success for investors as they respond to these changes.

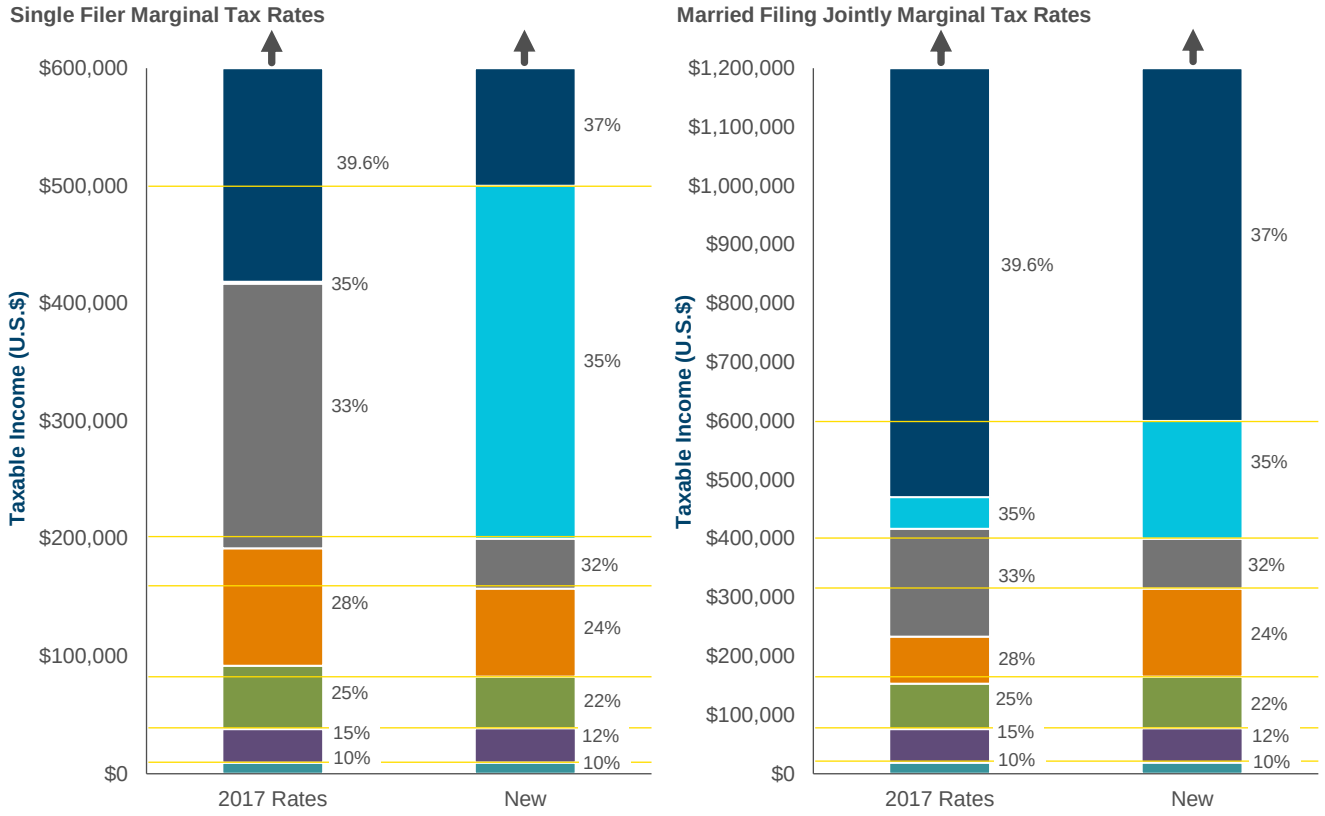
Among the biggest changes in the tax measure is a dramatic reduction in tax rates for corporations and closely held businesses. This means that business owners, including corporate shareholders, will be able to keep more of their businesses' profits. While the effects of the new taxation structure will vary widely by sector and among companies, overall it should be positive for owners and equity holders.

The tax overhaul reduces marginal tax rates for individuals at most income levels (see Figure 1). As a result, many people can expect to see lower tax bills over the next eight years. At the same time, individual tax deductions will be impacted. Changes include elimination of the personal exemption, increases in the standard deduction, and the

reduction or elimination of certain itemized deductions. Perhaps the biggest change to itemized deductions is that deductibility of state and local taxes (including property taxes) will be capped at $10,000.These changes make it more likely that many individuals will use the standard deduction instead of itemizing.

Figure 1: **Individual Marginal Tax Rates**

As of January 1, 2018



Source: U.S. tax reform measure.

Notes: Yellow lines represent the new tax bracket boundaries. For single filers, those bracket boundaries are $9,525; $38,700; $82,500; $157,500; $200,000; and $500,000. For married filing jointly, those bracket boundaries are $19,050; $77,400; $165,000; $315,000; $400,000; and $600,000.

BE PREPARED FOR CHANGES

One lesson from this process is that rules can change. The 2016 election and tax reform process highlight how uncertain the political landscape can be. The long-term impact of the measure is uncertain, as many of its provisions for individuals automatically expire after 2025 and would require approval from a future Congress and president to extend them. This means lower tax rates in the near term could be followed by rate increases down the road.

THE IMPORTANCE OF TAX DIVERSIFICATION

One potential way for investors to reduce the impact of tax changes on their retirement savings is to diversify the tax treatment of their money. This means having assets in accounts with differing tax structures, such as traditional pretax savings vehicles, Roth accounts (which feature potentially tax-free withdrawals), and taxable accounts. If investors expect that their tax rates will be higher when they withdraw money from their accounts during retirement, Roth accounts may be more attractive than pretax accounts. Even if investors are not sure what their future tax status will be, Roth assets can be a hedge against higher postretirement tax rates.

Many people have limited Roth assets, since those accounts are a relatively recent development and Roth individual retirement accounts (IRAs) are subject to income limitations. With that in mind—and since tax rates will mostly be lower in 2018—we think investors looking for more tax diversification should consider making Roth contributions. However, they should evaluate their own situations: High earners who expect significantly lower income in retirement (and potentially lower tax rates as a result) may still prefer to make pretax contributions.

KEEP SAVING

If investors are paying less in taxes next year, they may have more money to save toward their retirement goals. This may allow them to boost their retirement savings to the 15% or more of current salary (including any employer match) that we typically recommend.

Another impact to remember is that reduced tax revenues will put pressure on the federal budget. It is hard to predict what those changes might be and whether they would affect benefits like Social Security and Medicare. However, the possibility of change highlights how important it is for savers to control their own financial futures. Many investors rely on their own savings plus Social Security to fund a retirement that could last decades. The more they save now, the less they will need to rely on a Social Security system that is facing significant funding challenges.

REBALANCE YOUR PORTFOLIO

It is difficult to predict how tax reform will affect investment markets and by how much. This reinforces our belief in long-term strategic investing, with a diversified asset allocation based on each investor's time horizon and risk tolerance. But a long-term strategy still requires periodic adjustments. For example, recent gains in the equity markets may have caused asset allocations to drift, leaving investors with more equity exposure than they intended. Rebalancing is a disciplined way to manage investment risk. This could be a good time for investors to rebalance their portfolios if they haven't done so recently.

CONSIDERATIONS FOR SMALL BUSINESSES OR SOLE PROPRIETORS

The tax measure allows some business owners who report net business income on their individual tax returns to deduct 20% of that income (known as pass-through income). The rules around this provision will be complicated, and deductibility starts to phase out at $315,000 of income (for a married couple filing jointly). However, if taxpayers have been considering starting their own businesses, the lower effective tax rate could improve future financial projections and make entrepreneurship more attractive.

The lower effective tax rate on pass-through income also may affect how many business owners think about retirement investing. The marginal tax rates they face today could be lower than the rates they will face when taking distributions after retirement (since those withdrawals will be taxed as ordinary income.) One strategy for small business owners to consider is making sure their company (or solo) 401(k) plans have a Roth option.

529 ACCOUNTS

The tax overhaul allows state-sponsored college savings plans (529 plans) to offer tax-free withdrawals up to $10,000 per year per child for qualified elementary and secondary school tuition expenses. Previously, assets in 529 plans could only be used without penalty for higher education expenses. This is another incentive for individuals to save more for education using 529 plans. If their state offers a tax deduction for 529 contributions, and they haven't yet taken advantage of that tax break, investors may want to consider creating or adding to 529 accounts before the state's deadline. It's important for investors to consider their time horizons when choosing among investment options, especially if they want to withdraw funds before college.

OTHER ASPECTS OF THE TAX LEGISLATION THAT MAY BE RELEVANT

- The deductibility of interest on new mortgages is now limited to the first $750,000 of loan principal, and deductions for home equity loan interest have been eliminated. Combined with the $10,000 limit on the

deductibility of state and local taxes (including property taxes), these changes may affect household budget and housing decisions.

- The individual health insurance mandate has been eliminated, starting in 2019. While this removes a penalty for taxpayers who elect not to purchase health insurance, there are significant risks to going without coverage.
- The estate tax exemption has been doubled. Most estates weren't subject to the estate tax under the 2017 limits, and this change means even fewer will be subject to it in the future. It is a good idea for taxpayers to review their estate plans upon changes in the measure, especially if they have not done so recently.
- The ability to recharacterize a Roth conversion is gone. In the past, if investors did a Roth conversion (i.e., moved assets from a pretax account to a Roth), they had the option of "undoing" it before they filed their taxes. That flexibility has been eliminated beginning in 2018. But if a Roth conversion still makes sense for taxpayers, this change shouldn't dissuade them from doing it—especially if they expect their top tax rate to fall in 2018.
- The income threshold for the alternative minimum tax (AMT) for individuals has been raised. Like the higher estate tax exemption, this change should reduce the number of people affected by the AMT. Planning for the AMT can be complex, so taxpayers who think they still might be subject to it under the new measure should consult with their tax advisors.

CONCLUSIONS

The U.S. tax reform measure is extremely complex, and the full effects of many provisions are still unclear. Remember that taxes are only one of many important factors in making financial decisions. We strongly recommend that investors consult with their tax advisors about the effects relative to their situation. That said, for many investors, tax reform appears to offer clear benefits.

Investors could take the opportunity to increase savings rates, reevaluate whether Roth or pretax savings are preferable, and rebalance portfolios. Even in times of uncertainty, a disciplined saving and investing approach along with investment and tax diversification can help investors achieve their financial goals.

Summary of Changes in the U.S. Tax Reform Measure

Provision	Current (2017 Law)	Tax Reform Changes
Individual tax rates	Seven brackets, with top individual rate of 39.6%.	Seven brackets with rates generally the same as, or lower than, current rates. (Marginal rates are higher at some income levels.) Top individual rate of 37%. **Rates (and most other individual tax provisions) revert to 2017 law after 2025.**
Personal exemptions, standard deduction	Personal exemption of $4,050 per person, subject to income limits. Standard deduction (for taxpayers who do not itemize) of $6,350 for single filers, $12,700 for married filing jointly.	Personal exemption eliminated. Standard deduction $12,000 for single filers, $24,000 for married filing jointly. **(Expires after 2025.)**
Child tax credit	Child tax credit up to $1,000, phased out for higher income levels.	Child tax credit up to $2,000 with significantly higher phaseout levels. Credit for other dependents up to $500. **(Expires after 2025.)**
Alternative minimum tax	A parallel tax system to the regular tax system with its own definition of taxable income, exemptions, and tax rates. Taxpayers must compute their income for purposes of both the regular income tax and the AMT.	Repeals corporate AMT. Retains individual AMT with higher exemption and phaseout thresholds, intended to reduce the number of households affected. **(Expires after 2025.)**
Capital gains and dividends	Capital gains and qualified dividend income are taxed at a maximum rate of 20% (0% for investors in the 15% or lower tax bracket, 15% for investors in the 25%, 28%, 33%, or 35% tax brackets).	No change to the tax rates (0%, 15%, and 20%) applicable to capital gains and qualified dividend income. The 0% rate applies to taxpayers with taxable income not over $38,600 (single filers) and $77,200 (joint filers). The 15% rate applies to taxpayers with taxable income not over $425,800 (single filers) and $479,000 (joint filers).
Mortgage interest deduction	Deductibility of interest on mortgage principal up to $1 million (principal residence and one other). Interest on home equity debt up to $100,000 may be deductible.	Deductibility limited to interest on $750,000 of principal for new mortgages. Deductibility of home equity interest (including existing indebtedness) eliminated. **(Expires after 2025.)**
State and local tax deduction	Deduction allowed for state/local property taxes and state income taxes (or sales tax, if higher).	Maximum combined $10,000 deduction for state and local taxes ($5,000 if married filing separately). **(Expires after 2025.)**
Medical expense deduction	Deductible for eligible expenses exceeding 10% of adjusted gross income (AGI).	Reduces threshold to 7.5% of AGI for tax years 2017 and 2018, then reverts to 10%.
Charitable contribution deduction	Deductible, subject to limits based on income.	Still deductible. Deduction limit for cash contributions to public charities increased from 50% of income to 60%.
Other itemized deductions	Variety of miscellaneous itemized deductions allowable to the extent exceeding 2% of AGI.	All deductions subject to 2% AGI floor are repealed. Moving expenses no longer deductible. Alimony payments no longer deductible for payor (or included in income for recipient) for divorces finalized after 12/31/18. **(Expires after 2025.)**

Summary of Changes in the U.S. Tax Reform Measure (Continued)

Provision	Current (2017 Law)	Tax Reform Changes
Qualified distributions from 529 plans	Distributions used for qualified higher education expenses (college) not includible in income. Expenses for K–12 education do not qualify.	Allows 529 plans to be used for elementary and secondary education tuition expenses, up to $10,000 per beneficiary per year.
Requirement to purchase health insurance (individual mandate)	The Affordable Care Act imposes a penalty based on family size and household income for people without health coverage.	Penalties are eliminated starting in 2019. **(Expires after 2025.)**
Roth IRA conversions and recharacterizations	Recharacterization allows you to "undo" or "reverse" a conversion to a Roth IRA.	Repeals rules that allow individuals to recharacterize Roth IRA conversions.
Estate tax	Assets up to $5.49 million (individual) and $10.98 million (married couple) are exempt, indexed for inflation.	Doubles exemption. **(Expires after 2025.)**
Corporate rate	35% maximum rate.	21% flat rate.
Corporate taxes	U.S. companies taxed based on profits earned globally, with complex rules.	Significant changes to international taxation rules and deductions (with continued complexity). Temporarily allows full expensing of investments.
Pass-through entities	Income taxed at individual rates for owners (not the business itself).	20% of certain qualified business income for these owners may be deductible from income taxed at individual rates. Subject to complex rules and dollar limitations.

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