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Tax Reform Takeaways

The new tax law highlights the importance of a flexible investing strategy.

KEY POINTS

- Investors may want to consider Roth accounts in light of the new tax law.
- A lower tax rate may help you boost your retirement savings to the 15% recommended target.
- Remember to periodically rebalance your portfolio.

The U.S. tax reform measure that passed in December 2017 could have wide-reaching effects on financial planning decisions for millions of Americans. As investors consider the changes, it's important to remember that a strategy based on fundamental planning principles still offers the best path to success.

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Among the biggest changes in the 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.

The tax measure benefits many individuals as well. First, it reduces marginal tax rates for individuals at most income levels (see "Individual Marginal Tax Rates"), which means many people can expect to see lower tax bills over the next eight years. The tax measure also impacts individual tax deductions in ways that make it more likely that taxpayers will use the standard deduction instead of itemizing.

Revisit your investing strategy

Taxpayers may want to think about ways to optimize their investing under the plan. Here are four key takeaways to consider:

1. Look for tax diversification

One way to reduce the impact of tax changes on your retirement savings is to diversify the tax treatment of your money. This means having assets in accounts with differing tax structures. If you expect your tax rates will be higher when you withdraw money from your accounts during retirement, a Roth account with tax-free withdrawals may be more attractive than a traditional pretax account. Even for investors who are not sure what their future tax status will be, Roth assets can be a hedge against higher postretirement tax rates.

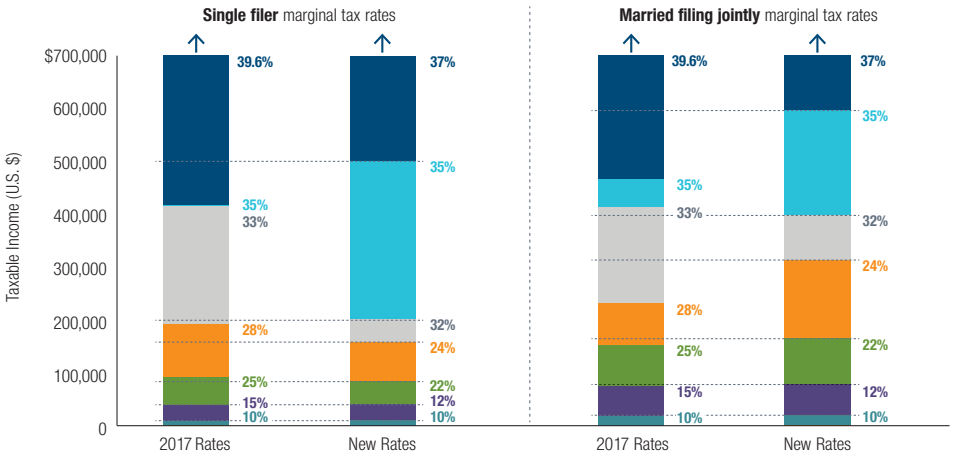
2. Keep saving

If you are paying less in taxes now, you may have more money to save toward your retirement goals. This could allow you to boost your retirement savings, targeting 15% or more of your current salary (including any employer match).

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.

Individual Marginal Tax Rates

Many taxpayers are seeing lower rates in 2018.



Source: U.S. tax reform measure.

Notes: Dotted 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.

3. Rebalance your portfolio

It is difficult to predict how tax reform will affect investment markets. That said, long-term strategic investing, with a diversified asset allocation based on each investor's time horizon and risk tolerance, remains the wisest path. A long-term strategy still requires periodic adjustments, however. For example, gains in the equity markets in recent years 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. Consider when you may want to rebalance your portfolios if you haven't done so recently.

As investors consider the changes, it's important to remember that a strategy based on fundamental planning principles still offers the best path to success.

4. Consider 529 accounts

The tax overhaul also 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 should be an incentive for individuals to save more for education using 529 plans. Remember to consider your time horizon when choosing among investment options.

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 for some businesses 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.

Be prepared for more changes

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.

Remember that taxes are only one of many important factors to consider in making financial decisions. A disciplined saving and investing approach, along with investment and tax diversification, can help you meet your financial goals. Consult with your tax advisor about how the changes will affect your particular situation.

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

Many areas of the tax law are affected.

Provision	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, 2017 rates. 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 of $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 (AMT)	A parallel tax system to the regular tax system with its own definition of taxable income, exemptions, and tax rates.	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 0%, 15%, or 20%, depending on taxable income.	No change to the tax rates applicable to capital gains and qualified dividend income.
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%.

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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.)
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).
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. ■

Source: U.S. tax reform measure.

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