TFC FINANCIAL
The Financial Counselors

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OUR VIEW

The Current Tax Environment: What is Certain for 2018 and How the Proposed Tax Legislation Will Impact Taxation of Investment Portfolios.

There has been much news recently concerning the proposed tax legislation moving through both the U.S. House and Senate. Significant negotiations and changes are likely before a final tax reform bill is passed into law, if the proposed legislation can garner the votes needed to pass both houses. Stay tuned and we will follow up if actual tax reform is passed into law.

For now, we will focus what is certain at this time and how the proposed legislation will specifically impact retirement savings and investment portfolios.

There are actual changes certain for the 2018 tax year, which while simpler than tax reform proposed on Capitol Hill, are worth reviewing as your savings levels may need to be adjusted to maximize allowable tax deferrals or tax-free savings as we finish 2017 and begin 2018.

Based on the recent IRS announcement on October 19th, here is what is currently certain for 2018 for tax and retirement plan limitations:

- Employer Retirement Plans Contributions The contribution limit for employees who participate in 401(k), 403(b) and 457 plans is moving from $18,000 in 2017 to **$18,500** in 2018.

- Employer Retirement Plans Catch-up Contributions The catch-up contribution for employees over age 49 who participate in 401(k), 403(b) and 457 plans will remain unchanged in 2018 at **$6,000**.

There are actual changes certain for the 2018 tax year.

- Deductible IRA Contribution Income Limitations For those covered by an employer retirement plan, the income level for determining eligibility to make deductible contributions to Traditional IRAs is increasing in 2018:

    - For single taxpayers covered by a workplace retirement plan, the phase-out range is gross income of **$63,000** to **$73,000** in 2018, up from $62,000 to $72,000 in 2017.

    - For married couples filing jointly, where the spouse making the IRA contribution is covered by a workplace retirement plan, the phase-out range is gross income of **$101,000** to **$121,000** in 2018, up from $99,000 to $119,000 in 2017.

    - For an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered, the deduction is phased out if the couple's gross income is between **$189,000** and **$199,000** in 2018, up from $186,000 and $196,000 in 2017.

The House and Senate tax bills will need to be negotiated to a single, agreed upon bill to be passed into law.

- Roth IRA Contribution Income Limitations The gross income phase-out range for taxpayers making contributions to a Roth IRA is $120,000 to $135,000 in 2018 for singles and heads of household, up from $118,000 to $133,000 in 2017. For married couples filing jointly, the gross income phase-out range is $189,000 to $199,000 in 2018, up from $186,000 to $196,000 in 2017. Eligibility for Roth IRA contributions are not linked to coverage by an employer retirement plan.

- Traditional and Roth IRA Annual Contributions The maximum annual contributions to an IRA and catch-up IRA contributions (if over age 49) will remain unchanged in 2018 at $5,500 and $1,000 respectively.

- Health Savings Account Contribution The maximum annual deductible contributions to a Health Savings Account (HSA) will increase in 2018 to $3,850 (from $3,400) for an individual and $6,900 (from $6,750) for a family.

Planning Opportunity: If your employer offers a Roth 401(k) account in addition to a Traditional (deductible) 401(k) account, now would be an appropriate time to review whether you should be contributing to a Roth 401(k). The Roth 401(k) option provides tax-free growth and tax-free distributions, but foregoes the tax deduction for contributions. The decision between the two is largely based on a review of your current and future expected effective tax rate, but other factors such as your age, reducing your future tax exposure and liability, the tax nature of your other savings, and your personal preferences should all be considered.

The House and Senate tax bills will need to be negotiated to a single, agreed upon bill to be passed into law. For our review of the proposal's tax impact on investment portfolios, we look at proposed changes to the tax rates and brackets for investment interest (ordinary income), non-qualified dividends (ordinary income), short-term capital gains (ordinary income), qualified dividends (long-term capital gain income) and long-term capital gains (long-term capital gain income).

Proposed Change #1: Both bills make 35% (current top bracket is 39.6%) effectively the top ordinary income tax bracket for most taxpayers, unless taxable income exceeds $1,000,000. This provides a modest reduction in tax on ordinary income (i.e., short-term capital gains, investment interest, and non-qualified dividends) for higher income investors. The income amounts corresponding to each new tax bracket are reduced in the House proposal (but not significantly in the Senate proposal) for some tax brackets creating a higher tax on lower income relative to the current tax bracket income thresholds.

Portfolio Tax Impact: For TFC managed portfolios especially in the current low-interest rate environment, the vast majority of taxable portfolio income is generated as qualified dividends and long-term capital gains, so the tax impact of a 39.6% to 35% highest bracket on ordinary income will be positive but muted for investment portfolio net of tax returns.

Proposed Change #2: Neither bill currently proposes changes to long-term capital gains rates which are 0%, 15%, and 20% corresponding to ordinary income tax bracket thresholds of 0-15%, 25-35%, and 39.6% (e.g., if your ordinary income is taxed at 25% your capital gain tax rate moves from 0% to 15%). The house bill does reduce the corresponding ordinary income thresholds creating a higher capital gains tax rate at lower ordinary income tax rates.

Ordinary Income Tax Rate	Current LT Capital Gains Tax Rate	Proposed LT Capital Gains Tax Rate
10%	0%	
12		0%
15	0	15
25	15	20
28	15	
33	15	
35	15	20
39.6	20	20

No material change in relative ordinary income and capital gains rates are being proposed.

Portfolio Tax Impact: Some investors who are currently subject to the 15% rate will be subject to the higher 20% long-term capital gains tax rate under the proposal. The 20% long-term capital gains rate is still lower than the proposed 25% ordinary income tax rate on taxable income over $90,000 (Married Filing Jointly) so long-term capital gains and qualified dividend income remain relatively attractive from a tax standpoint to ordinary income under the proposed tax reform.

As is currently the case, we will continue to be selective and prudent when reviewing the tax impact of prospective investments and placement of portfolio holdings in tax deferred, tax-free, or taxable accounts.

Lastly, the proposed tax reform framework limits or eliminates most itemized deductions other than mortgage interest and charitable contributions. Investors itemizing deductions can currently deduct investment management (IM) fees for taxable accounts, but only to the extent IM fees and other miscellaneous deductions exceed 2% of Adjusted Gross Income (AGI) for investors not subject to the Alternative Minimum Tax (AMT). The possibility of IM fees being deductible varies widely based on personal circumstances. The proposed tax reform also include increases to the standard deduction which may offset the loss of the IM fee deduction for some investors.

Conclusions (based on still uncertain tax reform)

Tax rates will still be a meaningful drag on net investment returns under the proposed tax reform changes, but no material change in relative ordinary income and capital gains rates are being proposed which would prompt changes to portfolio design or allocation. Long-term capital gains rates are still lower than ordinary income tax rates for most investors.

It continues to be important to review decisions such as allocating savings to Roth IRA/401(k) or Traditional tax-deferred retirement accounts, and whether conversions to Roth IRA/401(k) accounts might make sense given your personal objectives and tax situation.

The tax reform bills propose changes to other aspects of the tax code for Form 1040 tax filers including but not limited to:

- Standard and itemized deductions
- Alternative Minimum Tax
- Alimony
- Estate and gift taxes

- Roth conversion rules
- Gains on sale of a residence

As the proposed tax legislation continues to evolve and we gain clarity on what actual tax changes will become law, we will continue to review for the impact to net of tax returns for your investment portfolios, in addition to financial and estate planning.

If you have any questions or would like to discuss please do not hesitate to contact your TFC advisor.

Sincerely,

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