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Dear Clients and Friends,

Welcome to the October edition of our "Partnering With You" newsletter. As we get closer to the end of 2017, it is a good time to review your income taxes and take any required planning actions. Let us know if we can help.

Jim, Pam, Ruth, Nikie, Todd, Cheryl, Sandy, Kimberly, Chris, Stephen and Rich

**Partnering With You - October 2017**



# Tax Reform or Not?

You can be forgiven if you're skeptical that Congress will be able to completely overhaul our tax system after failing to overhaul our health care system, but professional advisors are studying the newly-released nine-page proposal nonetheless. We only have the bare outlines of what the initial plan might look like before it goes through the Congressional sausage grinder:

We would see the current seven tax brackets for individuals reduced to three — a 12%, rate for lower-income people (up from 10% currently), 25% in the middle and a top bracket of 35%. The proposal doesn't include the income cutoffs for the three brackets.

The dreaded alternative minimum tax, which was created to ensure that upper-income Americans would not be able to finesse away their tax obligations, would be eliminated under the proposal. But there is a mysterious notation that Congress might impose an additional rate for the highest-income taxpayers, to ensure that wealthier Americans don't contribute a lower share than they pay today.

The initial proposal would nearly double the standard deduction to $12,000 for individuals and $24,000 for married couples, and increase the child tax credit, now set at $1,000 per child under age 17.

At the same time, the new tax plan promises to eliminate many itemized deductions, without telling us which ones other than a promise to keep deductions for home mortgage interest and charitable contributions. The plan mentions tax benefits that would encourage work, higher education and retirement savings, but gives no details of what might change in these areas.

The most interesting part of the proposal is a full repeal of the estate tax and generation-skipping estate tax, which affects only a small percentage of the population but results in an enormous amount of planning and calculations for those who ARE affected.

The plan would also limit the maximum tax rate for pass-through business entities like partnerships and LLCs to 25%, which might allow high-income business owners to take their gains through the entity rather than as income and avoid the highest personal brackets.

A huge unknown is which deductions would be eliminated in return for the higher standard deduction. Would the plan eliminate the deduction for state and local taxes, which is especially valuable to people in high-tax states such as New York, New Jersey and California, and in general to higher-income taxpayers who pay state taxes at the highest rate?

Undoubtedly the passage of significant tax reform will require compromise – either within the Republican Party or with Democrats. The process of reaching compromise will result in changes from the proposed framework.

# Managing Debt While Saving for Retirement

It's a catch-22: You feel that you should focus on paying down debt, but you also want to save for retirement. It may be comforting to know you're not alone.

According to an Employee Benefit Research Institute survey, 18% of today's workers describe their debt level as a major problem, while 41% say it's a minor problem. And workers who say that debt is a problem are also more likely to feel stressed about their retirement savings prospects.[1] Perhaps it's no surprise, then, that the largest proportion (21%) of those who have taken a loan from their employer-sponsored retirement plans have done so to pay off debt.[2] Borrowing from your plan can have negative consequences on your retirement preparedness down the road. Loan limits and other restrictions generally apply as well.

The key in managing both debt repayment and retirement savings is to understand a few basic financial concepts that will help you develop a strategy to tackle both.

## Compare potential rate of return with interest rate on debt

Probably the most common way to decide whether to pay off debt or to make investments is to consider whether you could earn a higher rate of return (after accounting for taxes) on your investments than the interest rate you pay on the debt. For example, say you have a credit card with a $10,000 balance that carries an interest rate of 18%. By paying off that balance, you're effectively getting an 18% return on your money. That means your investments would generally need to earn a consistent, after-tax return greater than 18% to make saving for retirement preferable to paying off that debt. That's a tall order for even the most savvy professional investors.

And bear in mind that all investing involves risk; investment returns are anything but guaranteed. In general, the higher the rate of return, the greater the risk. If you make investments rather than pay off debt and your investments incur losses, you may still have debts to pay, but you won't have had the benefit of any gains. By contrast, the return that comes from eliminating high-interest-rate debt is a sure thing.

## Are you eligible for an employer match?

If you have the opportunity to save for retirement via an employer-sponsored plan that matches a portion of your contributions, the debt-versus-savings decision can become even more complicated.

Let's say your company matches 50% of your contributions up to 6% of your salary. This means you're essentially earning a 50% return on that portion of your retirement account contributions. That's why it may make sense to save at least enough to get any employer match before focusing on debt.

And don't forget the potential tax benefits of retirement plan contributions. If you contribute pre-tax dollars to your plan account, you're immediately deferring anywhere from 10% to 39.6% in taxes, depending on your federal tax rate. If you're making after-tax Roth contributions, you're creating a source of tax-free retirement income.[3]

## Consider the types of debt

Your decision can also be influenced by the type of debt you have. For example, if you itemize deductions on your federal tax return, the interest you pay on a mortgage is generally deductible — so even if you could pay off your mortgage, you may not want to. Let's say you're paying 6% on your mortgage and 18% on your credit card debt, and your employer matches 50% of your retirement account contributions. You might consider directing some of your available resources to paying off the credit card debt and some toward your retirement account in order to get the full company match, while continuing to pay the mortgage to receive the tax deduction for the interest.

## Other considerations

There's another good reason to explore ways to address both debt repayment and retirement savings at once. Time is your best ally when saving for retirement. If you say to yourself, "I'll wait to start saving until my debts are completely paid off," you run the risk that you'll never get to that point, because your good intentions about paying off your debt may falter. Postponing saving also reduces the number of years you have left to save for retirement.

It might also be easier to address both goals if you can cut your interest payments by refinancing debt. For example, you might be able to consolidate multiple credit card payments by rolling them over to a new credit card or a debt consolidation loan that has a lower interest rate.

Bear in mind that even if you decide to focus on retirement savings, you should make sure that you're able to make at least the minimum monthly payments on your debt. Failure to do so can result in penalties and increased interest rates, which would defeat the overall purpose of your debt repayment/retirement savings strategy.

***1 Employee Benefit Research Institute, 2017 Retirement Confidence Survey***

***2 Employee Benefit Research Institute, 2016 Retirement Confidence Survey***

***3 Distributions from pre-tax accounts will be taxed at ordinary income tax rates. Early distributions from pre-tax accounts and nonqualified distributions of earnings from Roth accounts will be subject to ordinary income taxes and a 10% penalty tax, unless an exception applies. Employer contributions will always be placed in a pre-tax account, regardless of whether they match pre-tax or Roth employee contributions.***

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# Examining the Taxpaying Population: Where Do You Fit In?

***Sources for data: IRS Statistics of Income Bulletins, Spring 2017 and Summer 2017, Washington, D.C., [irs.gov/statistics](irs.gov/statistics)***

***What is adjusted gross income (AGI)?***

*Adjusted gross income, or AGI, is basically total income less adjustments for certain items, such as deductible contributions made to an IRA, alimony paid, and qualified student loan interest paid.*

Every quarter, the Statistics of Income Division of the Internal Revenue Service (IRS) publishes financial statistics obtained from tax and information returns that have been filed with the federal government. Recently published reports reflect data gleaned from 2014 individual federal income tax returns. These reports offer a snapshot of how the U.S. population breaks down as taxpayers.

## The big picture

For tax year 2014, U.S. taxpayers filed roughly 139.6 million individual income tax returns.[1] Total adjusted gross income reported on these tax returns was $9.71 trillion, resulting in a total income tax of $1.37 trillion. That works out to an overall average tax rate of 14.16% for all returns filed — the highest total average rate in the 10-year period represented by the statistical report.

If your 2014 AGI was $38,173 or more, you were in the top 50% of all federal income tax filers based on AGI. This group accounted for 88.7% of all AGI reported and paid 97.3% of total federal income tax for the year.

## A look at the top

How much AGI did it take to make the top 10% of all individual filers? Probably not as much as you might think. If your AGI was $133,445 or greater, you would have been one of the almost 14 million filers making up the top 10%. This group reported about $4.58 trillion in AGI (more than 47% of all AGI reported) and accounted for about 70.9% of total individual income tax for the year.

To make the top 5%, you would have needed $188,996 or more in AGI. You would have been among approximately 7 million filers who reported almost $3.5 trillion in total AGI and accounted for about 60% of total income taxes paid.

It's also worth noting that the top 3% of all 2014 individual income tax returns based on AGI accounted for 52.9% of total income tax paid for the year.

## The very, very top

For the 2014 tax year, 1.4 million returns had an AGI of $465,626 or more. These taxpayers make up the top 1% of filers, reporting almost $2 trillion in total AGI and responsible for just under a 40% share of the total tax haul.

The 1,396 income tax returns that showed $56,981,718 or more in AGI make up the top 0.001% (that's the top one-thousandth of 1%) of 2014 filers. These filers together reported over $207 billion in AGI and paid over 3.6% of taxes.

## Not all high-income returns showed tax

Of the 6.2 million income tax returns filed for 2014 with an AGI of $200,000 or more, 10,905 showed no U.S. income tax liability (the number drops to 3,927 if you eliminate returns filed by individuals who were responsible for income taxes to foreign governments and had no U.S. income tax because of a credit for such taxes paid).

Why did these high-income returns show no U.S. tax liability? The IRS report noted that these returns show no tax for a variety of reasons, including tax credits and deductions, most notably miscellaneous deductions and deductions for charitable contributions, medical and dental expenses, and investment interest expenses. A significant secondary factor was the deduction for taxes paid.

## Average tax rates

Dividing total tax paid by total AGI yields the following average federal income tax rates for the 2014 tax year:

| Top Filers (by Percentile) | AGI Threshold | Average Tax Rate |
|---|---|---|
| **0.001%** | $56,981,718 | 24.01% |
| **0.01%** | $11,407,987 | 25.92% |
| **0.1%** | $2,136,762 | 27.67% |
| **1%** | $465,626 | 27.16% |
| **5%** | $188,996 | 23.61% |
| **10%** | $133,445 | 21.25% |
| **20%** | $90,606 | 18.64% |
| **30%** | $66,868 | 17.19% |
| **40%** | $50,083 | 16.24% |
| **50%** | $38,173 | 15.52% |

[1] Excludes returns filed by dependents; based on final estimates for tax year 2014 reported in Spring 2017 Statistics of Income Bulletin

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Partners in Financial Planning, LLC is a fee-only financial planning and investment management firm located in Salem, Virginia. Our mission is to provide comprehensive, caring financial guidance that allows our clients to spend less time worrying about their finances and more time enjoying their lives.



## Is the Social Security Administration still mailing Social Security Statements?

Your Social Security Statement provides important information about your Social Security record and future benefits. For several years, the Social Security Administration (SSA) mailed these statements every five years to people starting at age 25, but due to budgetary concerns, the SSA has stopped mailing Social Security Statements to individuals under age 60.

Workers age 60 and over who aren't receiving Social Security benefits will still receive paper statements in the mail, unless they opt to sign up for online statements instead. If you're age 60 or older, you should receive your statement every year, about three months before your birthday. The SSA will mail statements upon request to individuals under age 60.

However, the quickest way to get a copy of your Social Security Statement is to sign up for a *my* Social Security account at the SSA website, ssa.gov. Once you've signed up, you'll have immediate access to your statement, which you can view, download, or print. Statement information generally includes a projection of your retirement benefits at age 62, at full retirement age (66 to 67), and at age 70; projections of disability and survivor benefits; a detailed record of your earnings; and other information about the Social Security program.

The SSA has recently begun using a two-step identification method to help protect *my* Social Security accounts from unauthorized use and potential identity fraud. If you've never registered for an online account or haven't attempted to log in to yours since this change, you will be prompted to add either your cell phone or email address as a second identification method. Every time you enter your account username and password, you will then be prompted to request a unique security code via the identification method you've chosen, and you need to enter that code to complete the log-in process.

## What are some tips for reviewing my Medicare coverage during Medicare Open Enrollment?

During the Medicare Open Enrollment Period that runs from October 15 through December 7, you can make changes to your Medicare coverage that will be effective on January 1, 2018. If you're satisfied with your current coverage, you don't need to make changes, but it's a good idea to review your options.

During Open Enrollment, you can:

- Change from Original Medicare to a Medicare Advantage plan, or vice versa
- Switch from one Medicare Advantage plan to another Medicare Advantage plan
- Join a Medicare prescription drug plan, switch from one Medicare prescription drug plan to another, or drop prescription drug coverage

The official government handbook, *Medicare & You,* which is available electronically or through the mail, contains detailed information about Medicare that should help you determine whether your current coverage is appropriate. Review any other information you receive from your current plan, which may include an Annual Notice of Change letter that lists changes to your plan for the upcoming year.

As you review your coverage, here are a few points to consider:

- What were your health-care costs during the past year, and what did you spend the most on?
- What services do you need and which health-care providers and pharmacies do you visit?
- How does the cost of your current coverage compare to other options? Consider premiums, deductibles, and other out-of-pocket costs such as copayments or coinsurance; are any of these costs changing?

If you have questions about Medicare, you can call 1-800-MEDICARE or visit the Medicare website at medicare.gov. You can use the site's Medicare Plan Finder to see what plans are available in your area and check each plan's overall quality rating.

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