Transcript

ANDY SCHREINER: Welcome to a special Fidelity tax reform video event. I'm ANDY SCHREINER, senior vice president of public policy at Fidelity. Just a few weeks ago, Congress and the president approved the most sweeping changes to the tax code since the 1980s. Passage of tax reform has major effects on the agenda in Washington, impacts the broader economy, and makes considerable changes to how you should think about your financial plan. Today, we're going to take a few moments to explain those tax changes, and how you should be thinking about it as both a tax payer and an investor. Shortly, I'll be joined by a number of Fidelity professionals to help me better explain the tax law, including ALICE JOE, vice president of government relations from our Washington office, JURRIEN TIMMER , director of global macro in Fidelity's investment division, and KEN HEVERT, head of retirement and income solutions. One quick note before we begin. The information I'm providing today is general in nature, applies to federal taxes only, and may not apply to your own specific situation. Fidelity does not provide tax advice. What we're sharing today should not be considered tax advice, and we encourage you to contact your own tax professional, if you need more information about your own specific situation. Now, I'm joined by ALICE JOE on our government relations team. Alice, welcome.

ALICE JOE: Great. Glad to be here.

ANDY SCHREINER: Great. So, Alice, we've been through a lot in the past few months on tax reform. Why don't you give us a sense of where we are today—how did we land where we're at today.

ALICE JOE: Yeah, well, actually, it was a very busy end of the year, last year, in Washington, with tax reform on the cusp of passage there. What many of us saw in the public was the final vote on the floor of the Senate and the House, and then we saw the press conference at the White House with all the members of Congress there speaking about the bill. But what we didn't see is the fact that there are months and months of work that went into this. I mean, tax reform was intended to be a simplification of the tax code. But in reality, it was a very complex process to get us to where we are, where we got a bill that can actually both chambers of Congress. And so, what we ended up with was a very comprehensive piece of legislation that exceeded 500 pages in length. And so, of course, naturally, it has some major significant changes to various parts of the tax code.

ANDY SCHREINER: That's great. Let's start right there. So, one of the biggest parts of tax reform, that had the most impact on businesses and the economy, was corporate rates, right? We heard a lot about changes to corporate rates this year, especially on passthrough businesses, small businesses, and the like. Can you talk a little bit about where we landed in the new law for corporations?

ALICE JOE: Yeah, so, the new tax bill reduced the corporate rate down to 21 percent, from the maximum 35 percent under the old tax law. And so, that's a significant drop for a number of companies out there. Now, unlike various parts of the bill, the corporate tax rate is permanent. So, it is not going to sunset in 8 to 10 years, like some parts will, but it's permanent; it's set in stone. It was set to take effect at the beginning of this year, in 2018. And so, companies are already starting to feel the effects of that. Businesses can also benefit from some new provisions that are also in the tax bill, including immediate expensing of capital expenditures, but at the same time, because of the corporate rate decrease, we saw a decrease in the government revenue. So, they needed to find some offsets for that. One of the things that they did in this new tax bill that affects companies is the fact that now business interest deductions are going to be limited. Another key change for businesses, particularly smaller ones, is the change to the rate for passthrough businesses. So, what the new tax bill did there was it now allows a 20 percent deduction on qualified business income, before applying the individual rates. So, the smaller businesses, those that aren't incorporated, will also be able to benefit from the new tax law. Now, for passthrough businesses, however, that change can be somewhat limiting, particularly for those companies that tend to have higher earnings, as well as certain types of businesses, aren't eligible to take the passthrough rate.

ANDY SCHREINER: Right. So, clearly, Alice, there's a lot of major changes for businesses. What about individual investors? What's new in the bill for them?

ALICE JOE: Yeah, so there are absolutely a lot of big changes for individuals, starting with the individual tax rate. So, what they did in the new tax bill was they kept the existing seven brackets for individuals, but what they did do was they changed the thresholds by which each bracket fell. But more importantly, they actually lowered most of the seven—six out of seven of those tax rates down so that taxpayers can start feeling the effects pretty quickly. What they also did was they increased the standard deduction. They essentially doubled it to now where individuals can take a standard deduction of $12,000. Couples filing joint can take $24,000, and that's actually going to be indexed for inflation. But one thing to note about both the standard deduction and the tax rates are that it is set to sunset in 2025. So, that basically means in 2026, we'll go back to the same tax rate of where we were last year in 2017. One of the other things that individuals will be impacted by is the state and local tax deduction that's out there. Under the new law, now you're limited to taking only $10,000 of state and local tax deduction for property tax, for income tax, and now even sales tax, as well. That's $10,000 for both individuals and for couples filing jointly. Another provision that, I think, individuals will be interested in is the mortgage interest deduction. So, the new law also lowered the level of new mortgage debt that qualifies for a tax deduction. It allows tax payers to deduct interest on mortgages of up to $750,000 beginning in 2018, going all the way through 2025. Now, existing mortgages will be grandfathered, and they won't be affected. In 2026 and beyond, the provision will go back to the rates that it was at 2017, meaning the tax payer can deduct interest on mortgages up to $1,000,000. The bill also suspends the deduction for interest on home equity loans, otherwise known as HELOCs to many, beginning in 2018. But again, it sunsets in 2025. And then, finally, the last piece, I think, individuals may be interested in is the change in the estate tax, where the new law essentially doubled the estate tax exemption from 5.6 million to 11.2 million per person. And obviously, 22.4 million for couples. This provision, like all the others, again, will sunset in 2025.

ANDY SCHREINER: Wow. So, there's obviously a lot of changes there for individuals. One thing that you and I both know, having been involved in this process over the past year is that, oftentimes, what's most notable about a bill is not what's in it, but what's not included in it, and we had a number of different provisions that were in and out throughout the process. Maybe you could just talk a little bit about what was not included in the new bill—so, what has not changed that investors need to be thinking about, as they're thinking about their planning now for 2018.

ALICE JOE: Sure. So, when you have comprehensive tax reform, obviously, there's going to be some tradeoffs where you're going to have to find the offsets to pay for some of the cuts. Knowing that corporate rates and individual rates were going to get cut—and that was a priority—we wanted to make sure that retirement savers weren't going to bear the burden of some of those cuts and end up facing some consequences there. So, we were actually really pleased to see that the new tax law preserves a lot of the retirement and savings incentives that are in there. So, for example, early in the discussion, there was debate on whether or not to require contributions into retirement plans, such as 401(k)s, to be made on a post-tax basis, or, quote, a Roth-type basis. But at the end of the day, that provision was left out, and so, now, retirement savers can continue to contribute to their plans on a pre-tax basis, and continue saving for their nest egg in the future. One other issue that I want to mention is also the legislation had contemplated—at least earlier version of the legislation—had contemplated limiting investors' ability to manage their capital gains tax. Ultimately, the law didn't include these accounting changes, so investors still have the flexibility to make the choices on how to save. The final bill also didn't touch any kind of taxes on sells of primary residences, and it also didn't change the capital gains rate as well. And then, finally, I would say that, we were really happy to see that Congress decided to preserve the deductibility of charitable contributions. And in fact, what they did there was, they actually increased the amount of deductions that individuals can take for cash contributions. Previously, it was 50 percent of AGI, and now it's 60 percent of AGI, which is your adjusted gross income.

ANDY SCHREINER: Great, great. So, Alice, now that tax reform is done, what are policymakers focused on now? In the 2016 elections, we had heard a lot about regulatory reform, some potential changes there, or deregulation. What should investors be thinking about now in 2018 on the policy agenda, now that tax reform has passed?

ALICE JOE: Yeah, so, regulatory reform can encompass a number of things. But if you're focusing on what regulations impact investors directly, that impact their ability to save and invest in finances, the one thing that comes to mind is electronic delivery. Regulators today have an opportunity to make some changes to some very archaic regulations that have been in the books for decades. Many service providers and plan sponsors out there are subject to a myriad of federal requirements that govern how, and when, and what manner, legally required financial documents can be delivered to both their plan participants, and their beneficiaries and other investors. Now, these laws have been in place for a while, and they haven't been updated to reflect the twenty-first-century technology that exists today. In fact, the Investment Company Institute estimates that about 96 percent of households that own mutual funds actually have access to the internet, and that customers prefer e-delivery. So, by having things delivered electronically, it allows them to immediately help with their finances, and actually own some of the outcomes of their decisions.

ANDY SCHREINER: And e-delivery definitely seems like a common-sense thing that most investors would be in favor of, but what about that extra four percent? There are some people who don't have access to the internet; there are other customers that we know that do prefer paper. What do we say to them?

ALICE JOE: Well, so, paper absolutely should be available to them, if they want it. The main goal, here, is to deliver communications in a manner that allows customers to take action when they need to. And so, we're looking to making sure that both paper is available to them, as well as electronic delivery. So, whichever means works best for the customer.

ANDY SCHREINER: Great, great. So, are there any other broader topics on the policy agenda coming up this year that our investors should be aware of?

ALICE JOE: Yeah, so, now that tax legislation is done, I think, policymakers are probably going to be looking at policies that aren't going to require tax incentives to pass the bill. So, for example, in the private retirement system, one of the policies that are looking to be implemented is this concept called open multiple employer plans—open MEPs, per se—that's really geared more toward smaller businesses, who currently don't offer plans. And so, it will help get more employees saving for their retirement. The good news about this is that there is bipartisan support, both on the Hill, and in the Administration for pushing forward with open MEPs. The other thing we could probably expect to stay in the public limelight is healthcare. As we know, the tax bill included some changes to the Affordable Care Act, but I think we're going to continue to see healthcare—a debate on that—and, what other changes that can be made to improve healthcare for the American public. And then, finally, one of the key priorities, I think, in this Administration, and certainly considered by Congress, is infrastructure. And so, it'll be interesting to see how Washington approaches that, and tries to get infrastructure reform done.

ANDY SCHREINER: Well, thanks so much for joining us, Alice, today, and helping us better understand the impacts of tax reform on our investors. Glad to see you here today. Thank you.

ALICE JOE: Thanks for having me.

ANDY SCHREINER: Now, we're going to talk a little bit about the tax law and its impact on the economy and the markets. Now I'm joined by JURRIEN TIMMER, directly of global macro in Fidelity's investment division. Jurrien, thanks for joining.

JURRIEN TIMMER: Thanks, Andy.

ANDY SCHREINER: All right. So, I know you've been looking at the new tax law and its impact on both the markets and economy. Why don't we start with the economy? What are you seeing?

JURRIEN TIMMER: So, this is a pretty unusual piece of fiscal stimulus, just because of when it's happening. Normally both fiscal and monetary stimulus happens at the bottom of a recession, when, obviously, the economy needs it, that's what Keynesian economics is all about. So, the fact that this is happening eight years after the expansion began in 2009, at a time when the economy is at full potential, if you will, is pretty unusual. And it's happening while the Federal Reserve—the central bank—is actually tightening policy. So, we have monetary tightening, and fiscal stimulus happening at the same time. And so, it's a question of whether one will offset the other, because they're not both complimenting each other. And so, long story short, the likely impact on the economy is going to be less than it otherwise would be. And our own internal estimates are that maybe it'll add three tenths of a percent to GDP growth for the next several years. Certainly helpful, but not a real game changer.

ANDY SCHREINER: Now, about the markets themselves, has it changed your outlook on stocks?

JURRIEN TIMMER: Yeah, it's really been quite amazing watching just the last few weeks unfold. The market always has this thing called a price discovery mechanism, if you will. And investors are trying to figure out what this means. And what we're seeing is a double-barreled impact. So, the first thing we're seeing is that the estimates for earnings growth are rising rapidly, as you would expect. So, for the S&P 500, a typical company probably wasn't paying the statutory tax rate of 35 percent on corporate taxes in the first place because they have ways of lowering taxes, so the estimates sort of on Wall Street are that they were paying on average about 26 percent as an effective tax rate, and now that's gone down to 21. So, that's obviously a tangible change to the tax structure. And estimates are that it's about $2 a share of earnings for every percentage point change in the effective tax rate. So, that would be a $10 increase in earnings per share. And it's interesting, because since last August when the prospects of tax cuts really started to get revived, there's been a clear acceleration in earnings estimates for 2018 and beyond. So, that's how the market is pricing in the effects on earnings of the reduction in corporate tax rates. But there's another angle to this, and that is that the markets valuation has gone up as well. The PE ratio for the S&P 500, using forward earnings estimates, has gone up two points to 19.3 times forward earnings, just since last August. I mean, that's not even six months ago. So, a pretty dramatic increase, and, in part, that's probably justified because, if you consider valuations from sort of a discounted cash flow perspective, if you have a sustained increase in earnings growth, that justifies a higher valuation. I mean, that's just the way the whole discount of cash flow model works. The question is, of course, how much, right? So, the market is getting this two-sided effect. It's pricing in higher earnings—so, let's say it's $10 a share, times a twenty multiple, that's 200 S&P points. But on top of that the PE has gone up two points. That's another couple of hundred S&P points. And the market is trying to figure out what is the right level. There's not a clear consensus yet. Even, like, when we hear or read about what companies are doing, some companies are passing the tax cuts onto their employees; others are maybe passing it on to their consumers—they will get competed away. Others will buy back shares, or buy other companies, or invest in capital spending. It's really a whole mixture of outcomes. And I think it might take a few months before we really know what the right numbers are.

ANDY SCHREINER: So, how should investors react to this situation, with tax reform passing, as you're pointing out, things kind of in flux, and the market is trying to figure things out. How should they react to that?

JURRIEN TIMMER: Yeah, the average investors, who is saving for retirement through a 401(k) or an IRA, or some sort of dollar cost averaging, I would say, it doesn't really affect an investor in any way, because investors should have a plan that makes sense for them. They have goals of what they need in terms of their income. They have a risk budget, if you will. They have an appetite for a certain amount of risk. And when you put those two together, you get a portfolio—sort of a benchmark portfolio—whether that's 60, 40, or 70—30 or 50—50—will vary with investors. And whether the economy grows by three-tenths more than it did last year, or whether earnings are growing at 15 percent or 10 percent, I don't think that really makes a different. You know, the portfolio should be what it is, and probably the most important thing to do for investors that are in the right portfolio that makes sense for them, is to rebalance from time to time. Because, if your portfolio should be 60, 40, and the stock market has a huge run, you may end up at 70, 30 or 80, 20 without doing anything. And then, you want to make sure you're still at that 60, 40, or whatever the ratio is, so that if and when the next correction comes, and it's always going to come—we know that—you want that correction to be on the 60 and not on the 80. So, in the current market, we call that sort of a happy rebalancing because it's a nice rebalancing, because you're taking profits basically. So, I would say, the most important thing right now, is to do what we always should do, and that's make sure investors are in the right portfolio and that they rebalance.

ANDY SCHREINER: Great. Well, thanks, Jurrien. Thanks for joining and sharing your thoughts on tax reform and impact on the markets.

JURRIEN TIMMER: Great. Thanks, Andy.

ANDY SCHREINER: Thanks. Now, I'm joined by KEN HEVERT, head of retirement and income solutions at Fidelity. Ken, welcome.

KEN HEVERT: Thanks, Andy. Great to be here.

ANDY SCHREINER: Great. So, we know this new tax law changes a whole range of different tax situations for individual investors, things from the standard deduction, to Roth recharacterization. Maybe you could talk a little bit about some of the things that are most top of mind for us, and that we think investors should be thinking about as they're trying to navigate what this new tax law means for them.

KEN HEVERT: Sure. As you pointed out, there are quite a few changes coming to the tax payers in 2018. New tax rates, changes to rules for small business owners, changes to the deduction rules. But as you know, every individual in every household, situation is different. And what's really important is that we really dig into the numbers. In many cases, people should consider consulting with a tax advisor. In some cases, there will be lower tax bills for individuals of the household. In some cases, maybe not. And so, it is really important that people understand what the new rules are and how they actually impact their own situation. One of the big areas that people have been focusing on is the deductions, right? So, what's happened here is an attempt to simplify the plan overall—the rules. The personal exemption and the standard deduction have been combined for a total of $12,000, so it's higher for individuals, and for people filing married jointly, it's actually $24,000. So, the standard deduction has actually gone up quite a bit, which would cause people to think about whether or not it makes sense to continue to itemize. The other changes, when it comes to deductions, is that the child deduction has increased to $2,000, and there's also a new non-child dependent credit of $500. So, there's a new set of deductions, they're higher, and, ideally, people will really need to take a step back and consider whether or not itemizing makes sense, considering these new deductions.

ANDY SCHREINER: Yeah, so, how should people be thinking about that, between itemization and the standard deduction, now, post-tax rule.

KEN HEVERT: Sure. Well, again, I think the main thing that they need to do is probably take a look at the numbers and really determine whether or not, for example, does it make sense to itemize charitable contributions. That's just one example. There are changes to rules around mortgage interest, so those are things that people should really be thinking about.

ANDY SCHREINER: OK. Now, how does this change anything for other tax incentives that are really front of mind for our investors, such as retirement savings tax incentives, health savings tax incentives, and the like? What do we think about that?

KEN HEVERT: Sure. So, clearly from a retirement and a health savings perspective, a very important goal area and focus for many of our customers and individuals. There have been no changes to the eligibility rules, no changes to contribution rules, no changes to the tax advantage treatment of those investments. OK, so in that regard, the rules have no effect, really, on retirement savings. And that goes for health savings accounts as well. One change, however, that does go into effect, is that in 2018, individuals will no longer be able to recharacterize a Roth conversion. OK? There's been a little bit of confusion around this. You can actually recharacterize a Roth conversion that was done in 2017 up until the recharacteration deadline in 2018. But any Roth conversions that are done in 2018 can no longer be undone going forward. So, you really need to make sure that if you're going to consider a Roth conversion, you understand what the tax liability is associated with those.

ANDY SCHREINER: OK. Great. Let's talk a little bit about estate planning. So, throughout the debate, we know that there were a number of different potential proposals out there, including potentially removing the estate tax all together. Where did that land, and what should investors be thinking about, with regards to estate tax plan?

KEN HEVERT: Sure. Well, they weren't removed all together, they were actually doubled. So, an individual can pass on $11.2 million—that's per person, or 22.4 million for a couple. So, essentially, the amounts were doubled per person. And of course, for wealthy families, that's a nice advantage—it's a great opportunity to pass assets onto individuals at the federal level in a more tax efficient way. But I think it also serves as a very good opportunity to remind all families that they should be thinking about their estate plan. How do we want to make sure that our assets are structured in such a way that the beneficiaries can receive those assets, in the most tax-efficient way that's possible. Now, one of the things that's also important to understand is that the estate tax rules revert to the current rules. Okay, so, there is a sunsetting of these rules. I also think it's very important for individuals to know that at the state level, there are tax considerations as well. In some states, they do not have an estate tax; in others, it's a little bit different. So, you have to understand what the state and local tax situation is also.

ANDY SCHREINER: Right, and we also know that states are considering different changes to their own tax situations, state to state—

KEN HEVERT: That's right.

ANDY SCHREINER: —and we'll continue to see some of that going on in the next couple of years.

KEN HEVERT: That's exactly right.

ANDY SCHREINER: What are some other top issues that investors should be aware of coming out of the tax bill. We talked about a number of them—the standard deduction, retirement savings, etc. What are some of the other things that they should be thinking about, especially as they're going into 2018, new planning year.

KEN HEVERT: Sure. Well, there's three or four that really come to mind. The first one is alternative minimum tax. A lot of people find the alternative minimum tax system a little bit confusing. It was essentially designed to ensure that high income earnings ultimately do end up paying some tax, and that they can't prevent paying taxes by piling up all different types of deductions. So, the alternative minimum tax will be based on higher income levels. And so, that's one thing. So, it's not going away, but the levels at which the AMT, alternative minimum tax, is triggered, have gone up. Another important change has to do with education savings, or specifically 529. So, 529 plans have been a very common way for people to save over the long term on a tax advantage basis for college. They're considered college savings plans. And the new tax rules allow families to actually use 529 savings to cover kindergarten through 12th grade expenses of up to $10,000 a year. So, this is a really nice opportunity for families or individuals who want to save for private education for a child, but perhaps they may not be planning to go to college in the future. So, it makes 529 plans a lot more flexible.

ANDY SCHREINER: Great. So, final question, here. I mean, clearly, we're not providing tax advice in any way, shape, or form, but what do we think that investors should be doing now.

KEN HEVERT: Well, clearly, they should continue—let me start with what they should continue doing, OK? First thing they should continue to do is make sure that they have a good handle on what their goals are, the short and long term, and make sure that they are taking full advantage of all of their savings options. We want to make sure that people are continuing to think about their time horizons, their risk tolerance, and to make sure that they've got diversified portfolios. That should always be something people are thinking about. As it relates to tactics and things that are tax sensitive, there's a few things that people should know. Number one is that, again, when it comes to retirement savings, there's no changes to eligibility or contribution amounts, or the treatment of those, so, they should continue to build their nest eggs as they have in the past. But when it comes to understanding whether or not the new higher standard deductions are more favorable than itemizing, they really should consult with a tax advisor to make sure that they understand what route is going to give them the better outcomes.

ANDY SCHREINER: OK. Great. Ken, thanks again for joining us today. And thank you all for joining as well. We hope you learned some new information about the new tax law, and how it will impact all of you. For more information, please visit our Fidelity website (Fidelity.com/TaxReform) for information on what investors and advisors should know about the new law. Please know that we are updating our information all the time, so even if you visited before, please bookmark it and come back and visit us again. Thanks again.