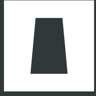

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You, Taxes & 2016

December 2016

As we come upon the end of another year, it is time to start thinking about the payment of taxes and what planning we can do to minimize the impact of taxes on our portfolios and our net worth. This brief white paper suggests a few areas where, if a little attention is paid now, it can mean savings come April 15th.

The first and most important piece of advice is to consult your tax advisor. The most effective partnership results are when we, as financial advisors, work with your accountant and form a financial team that is conversing throughout the year on topics where your investment and tax lives intersect.

When you do your taxes on April 15th (assuming no tax extension) it is basically a true-up of the taxes paid throughout the year, either done in payroll withholding or by the payment of quarterly estimated taxes. Let's start with the basics.

Refunds: You might like the idea of a big refund, but the term can be deceiving. In layman's terms, refund means that you gave the government an interest free loan for the better part of a year. Adjusting your withholding might solve this problem.

Underpayment: If you wrote a big check, it was probably not without interest and penalty. In that case, you paid for not paying enough. If one or the other happened due to a one-time event, then there is nothing to do. However, if your income is predictable, and you encountered one of these issues, it's important to review your payroll withholding, the amount you paid in estimated taxes or both.

Unearned Income: Check with your advisor for an estimate on dividend and interest payments that you received this current year. It is equally important to determine how you stand relative to capital gains or losses for the year. Many people are still working off losses from prior years, so check your tax return from last year and see what your carryover is. Then, find out what your gains are this year, as this will determine if you should consider extra estimated tax payments. Remember, the final estimated tax payment is due on or about January 15th.

One-Time Events: As mentioned above, if you had a one-time taxable event in the past year, such as the sale of a business or other asset, and you did not send in an estimated payment, speak to your accountant and determine a safe amount to remit to the IRS and State taxing authority in your estimated payments.

While these are helpful pointers, the more salient topic is tax saving ideas. See below for a few.

1. Capital Gains / Losses –

Pair off your gains and losses. If you haven't already taken carryover from past years, you start off each tax year at zero. If you have already taken $100k of capital gains from the sale of securities, your advisor should go through your account looking for losses to take, something referred to as tax-loss harvesting. Remember, if you take a capital loss on a security, you have to wait 31 days either before or after the sale to buy back the identical security. If not, the loss will be disallowed in something called a wash-sale.

While there is this wait period on capital losses, there is NO wait period if you take a capital gain. If you are still holding onto losses from prior years, you can sell that security you have been holding longer term with a huge gain and then buy it right back. This accomplishes two objectives -

a. You are able to use your capital loss with this offsetting gain. Remember you can only take up to $3,000 of capital losses in any year. The rest has to be carried over to the following year. Currently there is no expiration on the carryover of losses.

b. You have just increased your cost basis to today's value. Should there be a time in the future when you wish to sell the stock that you got from Grandma, you have just managed the capital gain in the process.

Remember, not all gains and losses are created equal. You first have to pair your short-term gains and losses and then separately pair your long-term gains and losses. Then, you pair them together. However short term gains (securities held less than 1 year) are paid at the higher of the capital gain rate or your income rate. Long term gains (held for more than 1 year) are paid at the capital gain rate of 20%. If you are in the higher tax bracket you may also be subject to the 3.8% surtax on long-term gains as part of the health care law.

2. Donation of appreciated securities:

Instead of selling the stock and paying the capital gain tax, consider donating it to your favorite charity. If you donate stock with a gain that you have held for at least 1 year, you receive a tax deduction for the full value of the gift, and pay no capital gains tax.

As an example, suppose you bought 200 Acme Online shares in 2010 for $10 a share or $2,000, and now Acme is up to $50 per share, a value of $10,000. If you sell Acme, you will owe approximately $2,000 in capital gains taxes (based on the new 20% rate and the ACA surcharge tax). You are left with $8,000. If you donate that same stock to Charity #1, they sell the stock for $10,000 and pay no taxes. You get a tax deduction worth $10,000. So you saved money in taxes and the charity received a larger donation… it's a win-win.

What about if you don't have a favorite charity or want to spread that $10,000 gift over two or more years, but want the entire deduction this year. What do you do? In this case, consider establishing a Donor Advised Fund. These funds work similarly to charities, except you control the timing of the donations. You can donate that same $10,000 of Acme Online shares to your family Donor Advised Fund, get the full deduction in the year of the original donation and then over the coming years, parcel out the proceeds at your pace to the qualified charities of your choice.

Having a Donor Advised Fund allows you to have complete control over when to take your charitable tax deduction and when the monies are dispersed to the charity(s) of your choosing.

You can also use a Donor Advised Fund as a great tool to teach the importance of charity to your children and grandchildren.

3. Retirement Plans:

If you are employed, your company probably has a retirement plan. If so, have you contributed as much as you can? Have you hit the maximum for 2016? For 2016, in a 401k plan the maximum is $18,000 + $6,000 catch-up if you are over 50. If you are 52 years old, you could make a total contribution of $24,000 to your 401k plan, not including a company match. This contribution comes out pre-tax and can therefore reduce your tax liability in the current year. Most importantly, the funds deposited to your 401k will grow on a tax deferred basis until you begin withdrawals.

What about a Roth 401k plan? If you are willing to forgo the upfront tax deduction, contributing to a Roth 401k might make sense. Contributions to a Roth 401k plan are done after tax, but the funds still grow tax deferred. After you retire or separate from service and you are over 59.5, the withdrawals are tax free.

The choice here is like the old candies …."Now & Later". As the package used to read **- eat some now save some for later.** Just like the candy, you can decide when to pay the taxes.

4. Personal Retirement Plans:

What if you are self-employed? There is still time to set up a retirement plan. For solo-proprietorships or small businesses, the last 10 years has seen a number of very affordable options in this space. Be they Uni401k plans, SIMPLE IRA's, SEP or even just a plain IRA, making contributions to a retirement plan is a quick and easy way to lower your current tax burden and save for your future.

5. Education planning:

By now, most of you have heard of 529 or college savings plans. These plans do not offer any current federal tax benefit for contributions, but many states do offer a deduction for contributions. Like an IRA these accounts grow tax deferred, and if the funds withdrawn are paid directly to an accredited college or university, there is no tax on the withdrawal. If you are a disciplined saver you can easily bank $100-200k for a child or grandchild and give them an incredible gift of college. However, if the child does not attend college, the funds are not theirs and can be redirected to another person - a sibling, a grandchild, a niece or nephew, a cousin…virtually anyone who is attending college.

6. Gifts to Family Members:

In 2016, the unified gift amount is set at $14,000. This is the amount that one person can give to another with no gift tax. A parent can give a child a $14,000 gift, and neither party has any tax liability. In this case, the benefit is getting the money out of your estate and planning for the longer-term estate tax (which is another topic). Be aware that if you give a gift of stock, the cost basis is passed along as well. If you

use highly appreciated stock to fund the gift your cost basis is passed along. If you are the recipient, it then becomes your choice to hold the stock and continue to defer the capital gains or sell them and pay the capital gains tax. In either case you are still ahead. As they say, never look a gift horse in the mouth.

7. IRA RMD:

If you are over 70.5 and you have an IRA account or multiple ones, be sure to complete your Required Minimum Distribution by December 31st. If you fail to complete the withdrawal the penalty is 50%, plus whatever the tax liability is. This is a steep price to pay for what might have been a simple oversight. And while you are taking your RMD, take the opportunity to double check your beneficiary designation and make sure they are up to date.

If you were the recipient of an inherited IRA from a parent or other relative (non-spouse) you too will be required to take an RMD, even if you are under 59.5. However, unlike a traditional IRA, the 10% penalty for early withdrawal is waived. In this case, the RMD is computed using your life expectancy and not the deceased who may have been considerably older.

This is only a short list of things you can do to plan your taxes for the current year. One important final thought - don't let the taxes wag the dog. Taxes should be a consideration when you are reviewing your investments and financial plan, but should not drive the process. Please call us to discuss any of the above issues. We welcome conversations with your Accountant directly to go through some or all of these topics to make sure we have properly planned for your 2016 tax season.

Remember one never plans to fail, but you can fail to plan.

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