Clarke, Snow & Riley, LLP

Tax Saving and Planning Strategies from Clarke, Snow & Riley, LLP

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Will The Third Shoe Drop?

As of this writing, major U.S. stock market indexes are extremely volatile. They're in the negative column for 2015, but that could change by the time this issue goes to press. In any case, it's likely that stock market values in late 2015 will still be much higher than they were in the dark days of early 2009.

Indeed, that's a key issue for year-end tax planning. The year 2000 was the last of Bill Clinton's eight years as President, and the stock market crashed, ending the tech boom. The year 2008 was the last of George W. Bush's eight years as President, and the stock market crashed, ending the real estate boom. The year 2016 will be the last of Barack Obama's eight years as President—will the current stock market boom meet a similar fate?

No one knows, but it's a possibility to consider. Stocks have always risen and fallen, so we could see a modest down year in 2016 or even a painful plunge.

What does this have to do with year-end tax planning? If you're concerned about a stock market dip, one strategy is to reduce your exposure to equities. However, most of your stock market holdings may be trading at prices higher than what you paid, so selling could trigger capital gains tax. What's more, recent tax increases may raise the tax bill on profitable sales.

In this issue, we'll present some ideas for reducing your exposure to a potential stock market slide without increasing your tax bill. Of course, that shouldn't be your only focus in year-end tax planning—we'll have tax-saving tactics in other areas—but if you have significant holdings of stocks or stock funds, you may want to consider some of these suggested strategies. ■

Year-End Investment Tax Planning

There's one certain way to avoid owing tax on capital gains: Don't sell any investments at a profit. At least, wait until January to take gains, postponing any tax obligation for a year.

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2015 Tax Planning Roundup

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Trusted Advice

Net capital losses

- If your capital losses in a given calendar year exceed your capital gains, you can claim a loss on your tax return.
- The amount of the net loss that you can claim on a joint or single tax return is the lesser of $3,000 ($1,500 if you are married filing separately) or your total net loss.
- If your net capital loss is more than $3,000 (or $1,500), you can carry the loss forward to later years.
- Capital loss carryforwards can offset future capital gains, which won't be taxed, and losses still unused can be deducted each year, up to $3,000 (or $1,500).

Moreover, there's an argument for staying the course with your stock market holdings. Historically, investors following a "buy and hold" strategy often have outperformed those who tried to move in and out of the stock market. Timing the market has been difficult, if not impossible, and that probably will be the case in the future.

In 2015, the broad U.S. stock market is more than 10% higher than it was at the 2008 peak, before the financial crisis drove down share prices. Investors who held on are ahead of where they were, and have collected seven years of (probably low-taxed) stock dividends in the interim. They've avoided paying tax on realized gains as well.

What's more, investors who truly maintained their strategy reaped another benefit. In late 2008 and in the following years, stocks were "on sale," as it turned out, selling at what proved to be low prices. Regular investing paid off, without a tax bill from taking gains.

Risk reduction

Staying the course and investing through turmoil sounds like a good way to survive a steep stock market reversal. In practice, though, that plan has flaws. Many people aren't emotionally equipped to hold onto assets that seem to be losing value, day after day, and to keep investing when stocks trade at lower prices.

Therefore, another tax-efficient way to lower your stock market exposure is to put future investment dollars into cash, bonds, or other asset classes.

Example 1: Art Young has a $500,000 portfolio, with $350,000 (70%) in stocks and $150,000 (30%) in bonds. Art invests $2,000 every month, with that same 70-30 ratio, stocks to bonds.

If Art is truly concerned about a stock market setback, he can stop putting more money into stocks. Starting with the fourth quarter of 2015, Art can put his monthly $2,000 investment entirely into bonds. Over the final three months of 2015 and throughout 2016, Art will invest $30,000 in bonds ($2,000 times 15 months). By year-end 2016, Art's $530,000 portfolio (without counting interest, dividends, or market moves) will still have $350,000 in stocks. His exposure to stocks will have dropped from 70% to 66%.

The 0% Solution

Instead of buying and holding, Art might sell equities to reduce his stock market exposure. However, profitable sales in his taxable account are likely to lead to a tax bill. Indeed, if Art is working and earning a substantial amount, he might owe 20% on any long-term capital gains, not the basic 15% tax rate. Art also could owe the 3.8% Medicare surtax, depending on the amount of income he reports for 2015. However, the situation could be different for Art's widowed mother, who has a modest income.

Example 2: Barbara Young estimates that she'll report $25,000 of taxable income in 2015, after her deductions. This puts her in the 15% tax bracket, which goes up to $37,450 of taxable income this year, for single filers.

For people in the 10% and 15% tax brackets, long-term capital gains are taxed at a 0% rate. As a result, Barbara can sell enough stocks to cause a $12,000 gain in 2015, and stay in the 0% bracket for long-term gains.

This strategy can work well for retired couples because the 15% tax bracket for a joint return goes up to $74,900 in taxable income this year. Married seniors might take enough long-term stock gains by year-end 2015 to fully fill up that tax bracket. Those gains will be taxed at a 0% tax rate, and the sellers can reinvest the proceeds elsewhere, if they want to trim stock market risk.

Gain from losses

Although taking gains in his taxable account will create taxes for Art, he can consider taking losses there. Energy stocks and funds have posted losses this year, and the same is true of precious metals securities. With the overall market barely ahead for the year, many individual issues have lost value.

By taking losses this year in his taxable account, Art creates an opportunity to take an equal amount of gains there, untaxed. If he wishes, Art can reinvest the proceeds in other asset classes or put them in the bank, to reduce reliance on stocks. ■

Did You Know?

Currently, 15 states and the District of Columbia have an estate tax, and six states have an inheritance tax. Maryland and New Jersey have both.

Source: Tax Foundation

Year-End Family Tax Planning

Another approach to reducing stock market exposure without incurring steep tax bills involves year-end gifts to family members. One way to use gifts in family tax planning is to transfer assets to youngsters such as your children or grandchildren. In 2015, the annual gift tax exclusion is $14,000. (See the article, "Year-End Estate Tax Planning," in this issue for more details.)

Example: Gil and Karen Martin, who have three children, own stock funds that have appreciated sharply since the purchase dates several years ago. In late 2015, Gil gives $14,000 worth of stock funds to their son Nick, $14,000 of those shares to their daughter Patti, and $14,000 to their daughter Renee. Karen does the same. Thus, the Martins have reduced their stock market exposure by a total of $84,000 (six $14,000 gifts) without owing any tax and without having to file gift tax returns.

After such a gift, the recipient retains the asset's basis (cost, for tax purposes) and holding period. Assume here that each $14,000 gift has an $8,000 basis, reflecting what Gil and Karen paid for the fund shares. Each child receives $28,000 of fund shares and would have a $12,000 long-term gain on an immediate sale of those shares.

Kiddie stuff

Depending on the age of the children and their school status, the so-called "kiddie tax" rules might come into play. Those rules are complex, but the youngsters to whom they apply include full-time students under age 24. For tax code kiddies, any unearned income over $2,100 this year would be taxed at the parents' rate. Thus, there would be little tax advantage for such gift recipients to sell the shares immediately.

On the other hand, children who have finished their education or reached age 24 generally are past the kiddie tax years. If so, they might sell the shares and owe 0% tax on all or part of the gains. Long-term capital gains are tax-free as long as taxable income is no more than $37,450 on a single tax return in 2015, or $74,900 on a joint return.

By the same logic, if Nick Martin is a 22-year-old student now, he can hold the appreciated shares until he finishes school or reaches age 24. At that point, Nick may be able to use the 0% tax rate on a profitable sale.

Alternatively, if the Martin children are very young, they could simply hold on to the gifted shares, as well as any shares they receive in future years. With their long-time horizon, the youngsters might be able to ride out market volatility, see the shares appreciate in the future, and take 0% gains at some point.

In any case, the Martins will have reduced their stock market exposure without owing tax, and they'll have helped their children build a college fund, pay off student debt, buy a home, or find another use for the transferred shares.

Senior strategies

Instead of (or in addition to) gifts to children, appreciated shares can be given to retired parents who might have modest taxable income. This plan can be especially attractive for taxpayers helping to support elderly relatives.

Example 2: Assume that the Martins are providing financial help to Gil's parents, who are living on a modest fixed income. Gil and Karen could each give $14,000 of appreciated stock fund shares to Gil's mother and $14,000 of such shares to Gil's father by year-end 2015, for a total of $56,000. If those funds pay dividends, the senior Martins could hold onto the shares and probably owe 0% on the dividend income. The same 0% tax rules for long-term capital gains also apply to qualified dividends.

Alternatively, Gil's parents could sell the gifted shares. Assuming the same basis as in example 1 ($8,000 per $14,000 of shares), their taxable gain would be $24,000, some or all of which could be taxed at 0%. The money could be used for retirement living expenses. With either the "sell" or the "retain" strategy, assets not depleted by his parents eventually could be inherited by Gil, perhaps with a basis step-up that would reduce tax on an eventual sale.

Again, Gil and Karen could help Gil's parents while reducing their exposure to a stock market retreat, yet owe no tax. Keep in mind that any late 2015 gifts can be repeated as early as January 2016, sheltered by next year's gift tax exclusion. ■

Year-End Retirement Tax Planning

One relatively easy way to reduce exposure to a possible stock market correction without taking taxable gains is to sell equities held in a tax-advantaged retirement account such as an IRA or a 401(k). Transactions inside these accounts don't generate taxes.

Example 1: Sue Taylor has $200,000 in her 401(k) and $200,000 in a taxable investment account. In both places, $120,000 (60%) is in stocks and stock funds, for a total of $240,000: 60% of her investments. Sue wants to cut back on equities, fearing the market will retreat.

As a result, Sue sells $60,000 of the stocks in her 401(k), reinvesting the money in bond funds and other asset classes besides equities. Now, Sue still has a $400,000 portfolio but only $180,000 (the original $240,000 minus the $60,000 she sold) in stocks and stock funds. Thus, her allocation to equities has dropped from 60% to 45%, leaving Sue less exposed to a steep setback. What's more, Sue owes no tax on the sale inside her 401(k).

To further reduce her allocation to stocks, Sue can reset her 401(k) contributions to reduce or eliminate equities. The last quarter of the year, when employees typically go over their company benefits, can be an excellent time to reset retirement plan asset allocations and future contributions.

Traditional tactics

Some perennial year-end tax planning moves for retirement make sense in 2015, as usual.

- If you're not already maximizing your contributions to 401(k) and similar plans, see if you can add some pretax salary deferrals this year. The 401(k) ceiling for 2015 is $18,000, or $24,000 if you're 50 or older.
- Execute Roth IRA conversions. You must have the account for at least five years (and be at least age 59½) to take totally tax-free withdrawals, but any conversion in 2015 gets a January 1, 2015, start date for the five year requirement. Your wait might be barely more than four years.
- If you're 70½ or older, make sure you take at least the 2015 required distributions from retirement accounts by December 31, in order to avoid a 50% penalty on any shortfall.

Planning for premiums

Some high-income retirees face a stealth tax: extra premiums for Medicare Part B, which covers medical costs. Although most Medicare enrollees pay about $105 a month for Part B in 2015, those with high incomes pay from $147 to $336 a month.

The Medicare Access and CHIP Reauthorization Act of 2015, signed into law in April, raises the stakes. Starting in 2018, Medicare enrollees with modified adjusted gross income (MAGI) over $133,500 ($267,000 on a joint return) will pay about $273 a month, plus inflation adjustments, versus around $210 a month this year. Those with MAGI over $160,000 ($320,000 jointly) will pay $336 a month, up from $272 now.

If the new rates take effect in 2018, why pay attention at year-end 2015? Because the 2018 Medicare premiums will be based on the income you report for 2016 on the tax return you file in 2017. Shifting income from 2016 to 2015, with year-end moves, may result in lower Part B premiums when those costs rise.

Planning for lower premiums shouldn't include shifting to municipal bonds, however, because tax exempt interest income is counted in your MAGI for this purpose. Instead, you might consider a Roth IRA conversion in 2015, rather than in 2016, to avoid boosting taxable income for next year. Converting a traditional IRA to a Roth IRA will reduce future required taxable distributions, and those distributions might push you into higher Part B premiums in future years. Our office can help you evaluate full and partial Roth IRA conversions, to see if they likely will help your total tax position, including lesser known pseudo taxes such as higher Part B premiums. ■

Year-End Charitable Tax Planning

The end of the year typically is a time for making charitable donations. If that's your practice, consider contributing shares of appreciated stocks or stock funds instead of cash. As long as the shares have been held longer than one year, you'll get a full tax deduction in 2015 for the appreciated assets, and the charity can easily cash in your gift.

Example 1: Beverly Carson donates $20,000 to her alma mater each year. In 2015, she decides to contribute $20,000 worth of shares of ABC Corp., stock she bought near the 2009 market low. Her basis in the donated shares is $6,000, in this scenario.

Here, Beverly gets the same $20,000 tax deduction she would get from a cash donation. The college, a tax-exempt entity, can sell the shares and keep the entire $20,000. Thus, tax on the $14,000 capital gain is never paid, and Beverly has reduced her stock market exposure by $20,000. The cash she would have donated remains in her checking account, for Beverly to spend or invest elsewhere.

Most investment firms and charitable organizations can help you execute a donation of appreciated assets.

Multiple choice

The tactic used by Beverly Carson might be fairly simple to implement, for one $20,000 donation. But what if Beverly's year-end philanthropy consists of five $4,000 donations? Or 10 $2,000 donations? The paperwork effort involved might outweigh the tax advantages, for many donors.

If you intend to contribute appreciated securities to multiple charities, consider going through a donor advised fund (DAF). Many financial firms and community foundations offer DAFs, which simplify such philanthropy.

Example 2: Dan Evans, who is concerned about a possible stock market collapse, typically makes $25,000 of charitable donations each year, spread among various recipients. Changing tactics a bit, in late 2015 Dan donates $25,000 worth of stocks and stock funds to a DAF. All of the shares are highly appreciated, after long-term holding periods. Dan's total basis in the donated shares is $10,000.

For this contribution to the DAF, Dan gets a full $25,000 tax deduction for 2015. After the shares have been sold, that $25,000 goes into his account at the DAF, with no reduction for capital gains tax. Then Dan can simply tell the DAF to distribute $4,000 to this charity, $6,000 to that charity, etc. There is no time pressure to make these contributions—and no threat to Dan's charitable tax deduction for 2015.

Thus, Dan has reduced his exposure to stocks, avoided capital gains tax, and reduced his tax bill.

Give and take

If your philanthropic intentions are significantly greater than Dan's or Beverly's, consider a charitable remainder trust (CRT). The principle is the same as it is for the strategies described previously: Donate appreciated securities to get a charitable tax deduction and, if it's a concern, reduce your exposure to a stock market now trading near record levels. In addition, you (and perhaps another beneficiary such as your spouse) can receive an income stream that might flow as long as an income beneficiary is alive.

CRTs come in two forms: annuity trusts and unitrusts. An annuity trust pays a fixed *amount* each year, with a minimum of 5% of the original contribution. A unitrust pays a fixed *percentage* of the trust value each year, with a minimum of 5% of the trust's value. You'll also get a partial upfront tax deduction for the fair market value of the remainder interest in the CRT that will eventually pass to the charity.

Example 3: Flo Grant uses $600,000 of highly appreciated securities to fund a charitable remainder unitrust in late 2015. The trust will pay 5% of its value annually to Flo or to her husband Harold, as long as either is alive.

An annuity alternative

Setting up and maintaining a CRT requires some effort and expense, so these trusts generally make sense if you have a substantial amount to contribute. You can get similar

benefits with a smaller contribution by acquiring a charitable gift annuity (CGA). Many charities and other nonprofits offer CGAs, often with minimum investments as low as $5,000 or $10,000. Typically, you need to be 50 or older to qualify for a CGA.

As mentioned, the mechanics of a CGA resemble those of a CRT. You donate assets—appreciated assets, such as stocks, are commonly used—to the sponsoring organization. In return, you'll receive a life-long stream of income; many CGA sponsors base their payouts on tables from the American Council on Gift Annuities (ACGA).

Example 4: Helen and Joe Lawson went to the same university. Now they're both age 65, and they want to fund a CGA from their alma mater. The ACGA's suggested maximum rate for such a couple is now 4.2%. The Lawsons contribute $50,000 of highly appreciated stocks to fund a CGA in 2015; they'll receive $2,100 a year (4.2% of $50,000) as long as either is alive.

Contributors to a CGA also receive an immediate partial tax deduction for the donation. Again, if you fund a CGA with appreciated stocks or stock funds, you'll reduce your exposure to a possible market crash without owing any income tax. ■

Year-End Business Tax Planning

As usual, the Section 179 "expensing" deduction is set for a drastic reduction. And, as usual, business owners probably can make year-end plans for equipment purchases with the expectation that a higher deduction amount for 2015 will be enacted.

Typically, purchases of business equipment are depreciated over several years, so the amount you spend can be deducted gradually from business income. However, the tax code allows some purchases to be deducted in full right away.

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Example: Brett Benson spends $20,000 on equipment for his manufacturing company this year. Brett can expense (deduct) that $20,000 to get an immediate tax benefit, rather than spread the tax savings over several years. Generally, an immediate tax savings is more valuable than a future tax savings.

By the numbers

For the expensing deduction, two numbers are critical. One is the maximum amount you're allowed to deduct. The other is the phaseout amount: the amount of equipment you can purchase before losing the expensing benefit. The phaseout provision essentially restricts this tax break to small and mid-sized companies because giant firms buy so much equipment that they lose the ability to expense any equipment outlays.

The tax code currently calls for the expensing deduction to be capped at $25,000, with a dollar-for-dollar phaseout beginning at $200,000. Thus, if your company buys $210,000 worth of equipment, the excess $10,000 reduces the expensing limit from $25,000 to $15,000.

In truth, those $25,000 and $200,000 numbers are not realistic today. Congress has repeatedly passed tax laws with higher limits: In recent years, expensing up to $500,000 worth of equipment has been permitted, with a phaseout starting at $2 million of annual purchases. All signs point to a repeat performance for 2015. Both Houses of Congress already have indicated willingness to extend some expired tax breaks, including the $500,000 and $2 million limits for expensing business purchases.

Therefore, you should go ahead with purchases of equipment that truly will help your company become more productive, even if this year's total tops $25,000. New and used equipment will qualify. Make sure to have equipment placed in service by year end, in order to get a deduction for 2015.

Similarly, the "bonus depreciation" tax break has expired but likely will be restored for 2015, judging by Congressional activity. Under this provision, which applies only to new equipment, purchasers can take a 50% first year depreciation deduction, followed by depreciating the balance of the purchase price over several years. Both expensing and bonus depreciation tax breaks reduce the cost of capital and increase cash flow for small companies, so you should consider their impact when planning equipment purchases. ■

Year-End Estate Tax Planning

In 2015, the federal estate tax exemption is $5.43 million. With little planning, a married couple can pass up to $10.86 million worth of assets to heirs, so no estate tax will go to the IRS. Those numbers will increase in the future with inflation.

With such a large exemption, you may think that estate tax planning is unnecessary. However, nearly half of all states have an estate tax (paid by the decedent's estate) or an inheritance tax (paid by the heirs) or both. The tax rate goes up to 16% in many states, or even higher in some.

What's more, state estate tax exemptions tend to be lower than the federal exemption; in some states, there is virtually no exemption for certain estates. Therefore, you may find year-end estate tax planning to be worthwhile, even if you don't anticipate having an estate over $5 million or $10 million.

Employing the exclusion

In terms of year-end planning, anyone with estate tax planning concerns (federal or state) should consider year-end gifts that use the annual gift tax exclusion, which is $14,000 in 2015. That is, you can give up to $14,000 worth of assets to any number of recipients, with no tax consequences. You don't even have to file a gift tax return.

Married couples can give up to $28,000 per recipient, from a joint account, or $14,000 apiece from individual holdings. Larger gifts probably won't be taxed because of a generous lifetime gift tax exemption, but you'll be required to file a gift tax return and there could be future tax consequences.

Example: Walt and Vera Thomas have two children. In 2015, Walt can give $14,000 worth of assets to their son Rick and $14,000 to their daughter Ava. Vera can do the same, moving a total of $56,000 from their taxable estate.

Similar gifts might be made to parents you're helping to support. As explained previously in this issue, giving appreciated stocks and stock funds to loved ones may be an effective way to reduce exposure to any market retreat.

Whatever your purpose, keep in mind that there is no spillover from one year to the next. If you miss making $14,000 annual exclusion gifts in 2015, you can't double up with a $28,000 exclusion gift in 2016. Moreover, make sure that gifts are completed—checks must be cashed—by December 31. Therefore, you should put your plans for year-end gifts in motion well before year end. ■

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