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2015 Tax Management Strategies

The beginning of the holiday season also means it's time for year-end tax management. And, given that our planning isn't compromised by impending tax policy sunsets, we have a great opportunity to develop comprehensive, long-term, individualized tax management plans based not only on your current tax rate, but on your anticipated tax rates for next year and in retirement. To that end, we are considering:

- **Tax Loss Harvesting.** In a fast moving volatile market like today's, investors can take solace in the fact that portfolio losses can have real value. Here's how tax loss harvesting works: When you sell positions for a loss, your losses can be used to offset the current year's gains and beyond that, up to $3,000 or ordinary income. Note, too, that even if you do not have any gains to offset, you can deduct up to $3,000 in losses from the current year from your ordinary income. Beyond that, any leftover losses over the $3,000 can be carried over and used to offset capital gains or up to $3,000 of income in the next year.

If all this sounds too good to be true, there is a caveat. The Internal Revenue Service's Wash-Sale Rule prohibits a taxpayer from claiming a loss on the sale of an investment if the same or a substantially identical investment is purchased within 30 days before or after the sale date. Time was when investors harvested losses and would just remain out of the market for those 30 days to avoid running afoul of the Wash Sale Rule. However, with the increasingly broad range of mutual funds and Exchange Traded Funds (ETFs), it is easy to find an effective work-around. After you harvest a loss, rather than sit with the sale proceeds in cash and wait 30 days to buy the security you sold back, you can invest in a "tax swap," a similar but not substantially identical security, to keep your client exposed to the asset class. The swap functions as a 30–day placeholder. After the 30 days, you can switch back to your original holding or stay invested in the tax swap. Keep in mind that if you switch back sooner, you are not allowed to claim the loss.

For example, let's say you have $6,000 in capital losses and $4,000 in capital gains. The $4,000 in losses first offsets the gains, leaving $2,000 to deduct against ordinary income. But remember, harvesting works even in years when there are no gains to offset –and these efforts can create real value over time. Harvesting can be especially beneficial when we take the extra step of considering what your capital gains rate is today versus what it could be in the future. Remember there are now effectively five capital gains rates –0%, 15%, 18.8%, 20%, and 23.8% due to the 3.8% Medicare surtax (see below for more detail.) Ideally, we'd harvest a loss, re-invest the sale proceeds, and you would have a lower capital gains tax by the time you sold the appreciated security. That said, the most ideal candidates for harvesting can an investor planning to retire in the next five or so years, or even a young two-earner couple that soon plans to have one spouse stop working to care for children over a period of years.

- **Taking capital gains.** Of course, if the potential for you to be in a higher tax bracket in the future, coupled with market swings the last few years, may make this a good time to harvest portfolio gains instead of losses. In particular, we might consider selling low basis stock positions you inherited or trimming back any over-exposure to company stock.

- **The 3.8% Medicare surtax**. Since 2013, individuals MAGI above $200,000 and couples filing jointly with MAGI above $250,000 have had to contend with an additional 3.8% tax on net investment income, or unearned income. This includes net rental income, dividends, taxable interest, net capital gains from the sale of investments (including second homes and rental properties), royalties, passive income from investments in which you do not actively participate (such as a partnership), and the taxable portion of nonqualified annuity payments.

Net investment income does *not* include tax-exempt interest from municipal bonds (or muni bond funds); withdrawals from a retirement plan such as a traditional IRA, Roth IRA, or 401(k); payouts from traditional defined-benefit pension plans or annuities that are part of retirement plans' life-insurance proceeds; veterans' and Social Security benefits; and income from businesses in which you actively participate, such as S corporations or partnerships.

While the tax is tough to avoid, we can invest in municipal bonds, if appropriate, and consider relocating dividend-paying stocks to tax-deferred accounts where that income would not subject to the surtax. Of course, another way to reduce your taxes is to reduce your income by contributing more to your 401(k) or IRA where your contributions grow tax-deferred.

Note that even if you don't qualify for a tax deduction for your IRA contributions, there are benefits to making a non-deductible IRA contribution because growth in tax-deferred retirement accounts is not subject to the 3.8% surtax. However, the contribution limit for 2015 and 2016 is just $5,500, or $6,500 if you're age 50 or older. The bonus here is that you have the option of later converting your traditional IRA to a Roth IRA. Remember, although there are income limits for opening a Roth IRA, there on no income restrictions on who can convert a traditional IRA to a Roth IRA.

- **Roth Conversions**. When deciding whether to convert to a Roth we evaluate how the conversion will impact your taxes this year versus the benefit of having a tax-free account to draw from in retirement. The optimal timing for a conversion depends on numerous factors and will be different for each investor. However there are a few obvious windows of opportunity to consider for a Roth conversion – One is prior to your peak earning years when your tax rate could be lower than just prior to retirement (or even in retirement!) and another is after you retire, but before you begin taking Required Minimum Distributions (RMDs) from your IRAs at age 70 ½.

- **Year-end capital-gains payouts.** Each year mutual funds must pay out to shareholders nearly all their income, including interest, dividends and net realized capital gains. If you hold mutual funds in tax-advantaged retirement accounts, those shared profits don't trigger a tax bill. Unfortunately, the same is not true of taxable accounts. In fact, a fund can even post a negative return for the year and still distribute gains that shareholders will owe taxes on. This scenario poses a real risk in the current volatile market where fund managers may have had to sell stocks in order to handle a lot of redemptions.

  Investment firms that haven't already estimated capital-gains payouts for 2015 will do so in the next few weeks. Distributions are listed on fund firms' websites, but they can take some hunting to find. If you'd rather not play detective, try consulting the free site, capgainsvalet.com. (I looked up some of the largest actively managed mutual funds and found that the preliminary estimated capital gains distributions ranged from none to as high as 9 percent.)

These capital gains distributions make buying a mutual fund at this time of year something to carefully consider. If you buy in early December and gains are distributed in late December, you will end up being taxed on gains you did not participate in for the full year.

I wish you and your family and friends a wonderful holiday season and a healthy and prosperous New Year.

Stay Diversified, Stay the Course!

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