Year-End Tax and Financial Planning Ideas

A year without change provides a nice respite. Will it last?

This is getting to be a habit. For the second year in a row, things have been very quiet year on the tax law front, at least for individuals. There was no significant tax legislation, and no significant IRS rulings. There were two Supreme Court rulings with tax implications this year, and while both were important neither resulted in sweeping law changes. One decision reaffirmed sections of the health care act; the other said that all states must recognize same-sex marriages performed in other states.

As in the last couple years, 2015 opened with the expiration of a variety of tax breaks that only a few weeks earlier had been extended retroactively for 2014. This includes making charitable gifts from IRAs, the deduction for teacher classroom expenses, and the exclusion of mortgage debt from income. These rules all remain expired as of mid-November, but there is widespread hope that they'll be extended retroactively again by the end of the year.

The majority of this inaction is because Congress and the President are unable to agree on the principal of any tax reform – one side is focused on raising additional revenue, the other on broadening the tax base. Another cause of this inactivity, at least in the most recent months, is that politicians are already beginning to focus on the 2016 Presidential election. That distraction is only going to become more pronounced as we head into 2016, so realistically the best chance for any significant tax legislation is probably after next fall's election.

Even though the federal tax code is relatively unchanged, that doesn't mean taxpayers will have a consistent tax experience from year-to-year. The old standbys of defer income/accelerate deductions still hold true in most cases, but no strategy always applies for all taxpayers. Taxpayers whose income will fluctuate significantly between 2015 and 2016 – due to job change, retirement, sale of a business, etc. – should consider perhaps different year-end strategies. Remember also that tax planning is not done in a one-year vacuum. The decision to accelerate or defer income or deductions, for example, should be done with an eye towards the tax impact over both this and next year. Lastly, many states have been more active in adjusting their tax code, and those changes should be considered in the context of year-end tax planning.

The below list of year-end tax and financial planning strategies is a starting point to discuss with a Baird Financial Advisor along with a tax consultant. While investment decisions shouldn't be driven entirely by tax issues, there are instances where sound investment decisions can be made that will decrease an investor's overall tax liability.

Planning for Capital Gains & Losses

Deciding to sell a portfolio position should be based primarily on the position's investment merits rather than purely the tax implications. However, understanding the implications of that sale can help drive the timing of a transaction. Unfortunately, determining the tax impact of realizing a gain or loss can be very complicated thanks to multiple tax rates, as well as the Net Investment Income tax.

- For 2015, taxpayers in the two lowest tax brackets will continue to enjoy tax-free long-term capital gains (assets held more than one year). While that doesn't mean low-income taxpayers can have an unlimited amount of tax-free gains, it does provide a planning opportunity for those taxpayers. Taxpayers who find themselves in those lower ordinary tax brackets for 2015 (taxable income below $74,900 for couples and $37,450 for singles) should consider realizing some tax-free gains this year. However, they should be sure to work with a tax advisor as there are rules limiting the overall benefit.
- Once taxpayers exceed those income levels, long-term gains will be subject to a 15% tax rate.
- Taxpayers reaching the highest ordinary tax bracket are subject to a 20% tax rate on their long-term capital gains. This rate applies for couples with taxable income over $464,850 and singles over $413,200 in 2015.
- Lastly, couples with Modified Adjusted Gross Income (MAGI) above $250,000 for 2015 ($200,000 for singles) will also owe a 3.8% tax on their investment income over those thresholds. Because MAGI is always equal to or greater than taxable income, taxpayers could be subject to this tax even though their taxable income ends up lower than this threshold. Also, the threshold for this tax is not subject to inflation adjustments, so taxpayers whose income was just below the threshold in 2014 may find they're over it for 2015.
- Other items, such as the phaseouts of deductions and exemptions (explained below), further complicate the marginal tax rate calculation.

Being aware of these breakpoints can help taxpayers better understand the cost of their investment decisions. For example, for those whose income is expected to drop in 2016 due to retirement, realizing a gain in 2015 may end up costing more in taxes than it would by deferring it to the next year when they'll be subject to a lower tax rate.

On the other hand, the investment risk associated with that deferral can't be ignored. Investors thinking of realizing a gain late in the year may be willing to accept the investment risk for a short time longer in order to defer the gain into January 2016. Investors facing that same decision earlier in the year may not be so willing to accept that risk for a longer time.

In addition to knowing the tax rate that will apply to capital gains, there are other considerations to keep in mind when it comes to managing gains and losses at year-end:

- Review net long-term and short-term gains and losses for the year to see if there may be an opportunity to sell a losing stock and offset gains from other sales. Since short-term gains (assets held one year or less) are taxed at the ordinary income tax rate, it's important to plan to offset those first, which may require realizing only short-term losses.
- Conversely, investors may look at realizing gains before year-end to absorb any losses realized earlier in the year. Capital losses are used first to offset capital gains. Short-term losses first offset short-term gains, and long-term losses first offset long-term gains. If there are net losses in one category, those losses can offset net gains in the other category. If total losses exceed total gains for the year, up to $3,000 of the remaining

losses can be used to offset other income. Losses in excess of this are carried over to the next year to offset gains in that year. These excess losses can be carried forward indefinitely.

- The market volatility that dominated the second half of 2015 may have led investors to recognize more gains or losses than in a typical year. As a result, it may be more difficult to come to a zero-net-gain or loss position for 2015.
- Another thing else to consider when trying to zero-out capital gains for the year: Investors that sold their mutual funds during 2015 forced fund managers to sell positions to generate cash. For investors that held those funds, it will likely mean larger capital gain distributions than were expected.
- Lastly, avoid the urge to recognize gains in order to "use up" losses realized during the year, only to immediately repurchase the item sold at a gain because it still is makes sense to own. Those losses can be carried forward to the next year, when there may be a gain that is appropriate to realize from an investment standpoint. Using up losses this year can result in taxable gains that can't be offset next year.

Other Investment Planning Strategies

Beyond issues concerning when to recognize capital gains and losses, there are other portfolio planning opportunities to consider before year-end:

- In order to fully deduct any investment interest expense paid during the year, an equal or larger amount of interest income and short-term capital gains must be recognized during the year. Investment interest is deductible only against those types of investment income, although excess interest expense may be carried over indefinitely to offset future investment income.
    - Investors also have the option of foregoing the lower tax rates on qualified dividends and long-term gains in order to treat those items as investment income for purposes of this deduction. Making this election essentially means taking a lower tax benefit for deducting that interest expense this year rather than carrying the deduction forward for perhaps a larger benefit in the future. Those considering this election should consult with a tax advisor who can prepare projections under both scenarios.
- Beware of the wash sale rules while divesting of investments at a loss. These rules prevent investors from deducting a capital loss from the sale of an item if they buy a "substantially identical" position during a 61-day period, beginning 30 days before the day of sale and continuing for 30 days after the day of sale. The wash sale rules don't apply to any sales for a gain, nor do they apply to gifts of appreciated stock to charity. While a loss under the wash sale rules is usually only deferred rather than permanently lost, taxpayers would likely prefer receiving the full tax benefit of any realized losses sooner rather than later.
    - An exception to the loss deferral after a wash sale is when an IRA is involved. Selling a security for a loss in a taxable account and then repurchasing it in an IRA can trigger the wash sale treatment. In this scenario, the loss on the sale is permanently lost. Therefore, investors must look across the entire portfolio when determining if the wash sale rules will apply.
    - Investment firms are required to account for wash sales when the exact same position is bought and sold in the same account. However, wash sales involving positions that are not exactly the same but that are "substantially identical" (such as selling a stock and then buying a

call option on the same stock) or when they occur over multiple accounts are not required to be tracked by those firms. Taxpayers will need to watch for those potential wash sales themselves.

- In order to claim a loss for a "worthless stock", an investor must be able to prove the stock had value at the end of 2014 but did not at the end of 2015. If it's uncertain whether the stock is truly worthless by the end of the year, owners will need to sell the stock for whatever value they can in order to claim a capital loss. In general, if the stock is still trading, it is not considered worthless. A bankruptcy filing by the company does not, on its own, indicate the stock is worthless.

Income Taxes

For the third year in a row, the top tax bracket for 2015 is 39.6%. The income level at which that rate applies, like that of all other tax brackets, has been adjusted upward for inflation this year. Beyond those annual inflation adjustments, there were no changes to the tax brackets for 2015.

- Taxpayers should review federal withholding and estimated income tax payments in order to avoid underpayment penalties. Even though a taxpayer's 2015 tax liability may have increased over 2014, it doesn't necessarily mean that increased tax must be paid to the IRS before the end of the year. To avoid a penalty for 2015, total tax payments must equal the lesser of (1) 90% of the current year tax liability or (2) 100% of last year's liability (110% if Adjusted Gross Income (AGI) was more than $150,000 for 2014). For those taxpayers whose 2015 income is the same or higher than it was in 2014, there's a good chance they can wait to pay the increased tax until they file their 2015 tax return in April 2016.
    - Taxpayers whose income in 2015 is lower than it was last year may instead prefer to remit just 90% of their projected 2015 tax liability before the end of the year, leaving the remainder to pay with their tax return. In order to provide some cushion for unforeseen events, it may be better to target 93-95% of the projected liability.
- While there may be an incentive to accelerate state tax payments into the current year (see below), there is generally no such incentive for federal tax payments. Other than paying enough to avoid an underpayment penalty, the best cash management strategy is to defer the balance of the federal tax liability until the due date for the tax return. Keep in mind that requesting an extension of time to file a tax return doesn't extend the time for paying the tax.
    - Washington DC recognizes Emancipation Day as a district holiday, and for 2016 the holiday is April 15. Because that is a Friday, the due date for 2015 tax returns, without filing an extension, has been moved to April 18, 2016. This gives taxpayers a few extra days to make those last payments.
    - Residents in Maine and Massachusetts celebrate Patriot's Day April 18, so residents of those states will receive an additional day to file their tax returns, to April 19.
- Taxpayers are often concerned that their tax rate will rise from one to the next, but in many cases the opposite actually happens. For example, those who retired in 2015, or plan to in 2016, may have a decreased level of income that could trigger a fall to a lower bracket next year, and that bracket could have a lower marginal tax rate. If that's true, deferring other income into 2016 from 2015 may be appropriate.

While it's difficult for most taxpayers to time the recognition of income, self-employed individuals or those whose income is primarily commission-based may have more flexibility here.

- Couples who were married in 2015 will be filing joint tax returns for the first time. The tax impact of this change in filing status could vary significantly depending on the couple's income level.
    - In situations where there is a significant difference in income between the two spouses, filing jointly may result in a net tax savings over what they each paid as single individuals.
    - In cases where each spouse has similar levels of income, however, the "marriage penalty" could result in an increased tax liability over what they paid as single taxpayers. Newly married couples should be prepared for this potential tax increase.
    - Couples getting married in 2016 should consider the timing of their deductions in order to maximize the tax benefit over the two-year period. Those expenses should be paid in the year they'll be subject to the highest marginal tax rate.
    - For same-sex couples, the requirement to file a joint federal tax return applies as long as they are legally married. However, several states still don't recognize the marriage, so they may need to file as two single taxpayers for state purposes. As a result, these couples should carefully review their projected federal and state tax liabilities in order to ensure they avoid underpayment penalties.
- In 2015, couples with AGI over $309,900 (singles over $258,250) will see their itemized deductions reduced by 3% of their income over that level. This phaseout results in an increase in the marginal tax of 1.0-1.2% for those affected.
    - The natural reaction is to cut back on expenses that can be deducted because it appears the full value of the expense isn't being realized. However, this approach is usually incorrect – the phaseout is driven almost entirely by income, not the amount of deductions claimed. For example, a taxpayer considering a large charitable contribution will still realize the full value of the deduction. However, recognizing a capital gain or taking an additional IRA withdrawal will drive up AGI, and thereby increase the amount of deductions lost to the phaseout, effectively increasing the tax cost of that additional income.
- Determine if it is better to pay deductible expenses (such as property taxes, charitable contributions, state estimated tax payments, etc.) before the end of 2015 or after.
    - For taxpayers whose income will increase in 2016, their deductions could be worth more next year, so deferring deductible expenses into next year would be appropriate in that scenario.
    - On the other hand, for taxpayers whose income will fall in 2016, it may make sense to accelerate deductions into 2015.
    - Another factor is whether or not the taxpayer may be subject to AMT in either year. Taxpayers subject to AMT essentially lose the benefit of deductions such as state income and property taxes and other miscellaneous deductions. While avoiding AMT can be difficult in some cases, doing a multi-year tax projection can help quantify the tax results under different scenarios.

  - This AMT issue is particularly important for those whose income is unusually high this year and is expected to fall again next year. The first thought is often to delay paying the full state tax liability until the return is filed. However, doing so will push the state tax deduction into the next year, when the larger deduction and decrease in income may combine to trigger an AMT liability. Paying the full state tax liability this year when income is higher can not only maximize the value of the deduction, but also help avoid AMT in the low-income year.
- Be sure to complete any charitable obligations prior to year-end in order to take a tax deduction for 2015. As always, utilizing appreciated property for contributions rather than cash can be a great tax savings tool. Those gifts will generate a deduction for the full value of the property without having to recognize a taxable gain.
  - When making charitable gifts, be sure not to gift securities that have a loss. By giving a position with a loss, the deduction is limited to the market value at the time of the gift, and neither the taxpayer nor the charity will receive any tax benefit for the built-in loss. Rather than donating something that has a loss, taxpayers are better off selling it first to realize the loss, which can then be deducted, and then gifting the sales proceeds to the charity.
  - Also be sure to donate only those items that would be considered "long-term" assets. Donating an asset that is considered a "short-term" holding will limit the tax deduction to the cost basis.
- Charitably-inclined taxpayers whose income is unusually large in 2015 (due to a sale of a business, stock option exercise, deferred compensation payment, etc.) may want to consider a donor advised fund. These funds allow taxpayers to make a gift in the current year, but then defer the distributions to charities until sometime in the future. With this type of gift, the tax benefit is realized immediately without having to commit to a specific charity until later. The gift to the fund is irrevocable, but these vehicles can be a great way to maximize the tax benefit of a donation.
- The law that allows eligible taxpayers to make charitable gifts directly from their IRA and not have to report the withdrawal as income (known as a Qualified Charitable Distribution, or QCD) expired at the end of 2014. This is one of the provisions that would likely be included in any tax extenders bill passed later this year, but until final legislation is passed, we have to assume the technique is not available.
  - Taxpayers make these types of gifts assuming the rule will be extended do so at their own risk. While this rule is usually extended retroactively, that hasn't always been the case.
  - Even if the QCD rule is not reenacted, taxpayers can still make a direct transfer from an IRA to charity. The withdrawal will be taxable, but the gift will be deductible, and for many taxpayers the net tax result is the same as making a QCD.
  - Also, donating appreciated property will in many cases lead to a better overall tax result than the QCD technique. The deduction for gifting the stock will still offset the IRA withdrawal, but the capital gain on the stock is also avoided, providing a double tax benefit.
- Consider bunching certain itemized deductions such as medical expenses and miscellaneous deductions in order to exceed the minimum AGI limitations. However, beware of AMT considerations that can reduce or eliminate any benefit from this planning.

- For most taxpayers, medical expenses are only deductible to the extent they exceed 10% of AGI. Taxpayers age 65 or older are still subject to the old 7.5% of AGI threshold, but only through 2016. This transition is due to a provision in the Health Care Act that took effect in 2013.

- As part of the 2010 health care act, taxpayers are now required to purchase health care coverage, and for 2015 the penalty for not purchasing has increased. For this year, the penalty is the greater of 2% of income or a flat $325 for a single person ($975 for a family). The penalty is calculated on a monthly basis, meaning purchasing coverage now won't avoid the penalty, but it can minimize it. For 2016, the penalty reaches its maximum level of the greater of 2.5% of income or $695 for a single person ($2,085 for a family). There are numerous exceptions to the penalty, so check with a tax advisor to determine the requirements under this rule.
- Like with itemized deductions, personal exemptions – the $4,000 deduction allowed for a taxpayer, their spouse and any dependents – are also subject to a phaseout. This phaseout is tied to the same income thresholds as the deduction phaseout, so the only way to avoid it is to keep income below those amounts. Parents may be tempted to allow their children to "claim themselves" if the parent receives a reduced benefit for the exemption. However, the exemption must be claimed by whoever is providing more than 50% of the support for that person, even if there is no actual tax benefit for the deduction. This phaseout is in effect another form of tax increase once income crosses the applicable threshold – something for taxpayers to consider before recognizing more income.
- Consider restructuring nondeductible interest expense (such as auto loans or credit card debt) to deductible interest (such as a home equity loan).
- Employees who have employer stock options should review their long-term strategy to determine whether to exercise any options this year. This is particularly true for those who hold Incentive Stock Options (ISOs). While these options only create income for Alternative Minimum Tax purposes, that still usually leads to an increased tax liability for many optionees.
  - Taxpayers who exercised ISOs in prior years may have paid AMT as a result of that exercise. The additional tax paid in those cases is often considered "creditable", and can be used to reduce taxes in years when the taxpayer is not subject to AMT. The ability to use this credit is something else to consider when recognizing income before year-end.
- The Kiddie Tax applies to children under age 19, or under age 24 if they are a full-time student. As a result of this, parents will find it difficult to shift investment income from themselves to their children for a tax savings. For 2015, the first $1,000 of unearned income (basically anything other than wages or self-employment income, such as interest, dividends and capital gains) is exempt from tax. The next $1,000 is taxed at the child's tax rate, but any income over $2,000 is taxed as if it were the parents' income, including the higher capital gain tax rates and the Medicare tax on investment income.

Retirement Planning

- Taxpayers should be sure to maximize 401(k) or other retirement plan contributions for which they are eligible. In most cases, the maximum contribution for 2015 increased over the 2014 maximum.

- Contributions to either a Traditional or Roth IRA should also be maximized, although these limits did not increase over 2014. Contributions to these accounts are limited to a combined $5,500 ($6,500 if age 50 or over) for 2015.
  - Those covered by an employer-sponsored retirement plan are subject to income limits that affect the ability to deduct contributions to a Traditional IRA. For 2015, married couples with income over $98,000 and singles over $61,000 will begin to lose the benefit of the IRA deduction. The deduction is fully phased out once income reaches $118,000 for couples, $71,000 for singles. However, being over that threshold does not prevent someone from making a non-deductible contribution (as long as they have earned income equal to or greater than the contribution amount).
  - Full contributions to a Roth IRA are only allowed for those with AGI below $183,000 for joint taxpayers ($116,000 for single taxpayers), with contributions phased out at $193,000 ($131,000 for singles).
- Taxpayers age 50 or older are usually eligible for a "catch up" contribution – an additional contribution amount over the base limitation. Those who turned 50 in 2015 should be aware of this increased IRA or employer plan contribution amount.
- Consider converting a Traditional IRA to a Roth IRA prior to year-end. There is no longer an AGI limit for Roth conversions, so all taxpayers are now eligible to do a conversion. The conversion amount will be fully taxable in the year of conversion (other than any previous non-deductible contributions to the account).
- Those who did convert a Traditional IRA to a Roth IRA may have seen the value of the account decrease since the time of the conversion. This is particularly true for those conversions done prior to the market volatility in the third quarter. If that's the case, those Roth IRA owners may want to consider reconverting that Roth back to a Traditional IRA, thereby negating the tax due on that formerly larger account balance. For conversions done during 2015, the deadline to recharacterize the Roth conversion is October 15, 2016.
  - Those who do recharacterize back to a Traditional IRA can then re-convert it back to a Roth IRA, subject to waiting periods. They must wait until the next taxable year after the original conversion to the Roth, or 30 days, whichever is later. This means that if a 2014 Roth conversion was recharacterized during 2015, it can then be reconverted back to a Roth after just waiting 30 days. If the original conversion was in 2015 and it was recharacterized this year, then the reconversion back to the Roth must wait until at least January 1, 2016.
- Once an IRA owner reaches age 70½, the Required Minimum Distribution (RMD) rules apply. Those IRA owners must take a distribution from their IRA by December 31, 2015, with the amount based on the January 1, 2015 value of the account. IRA owners who turned 70½ during 2015 are able to defer their first RMD until April 1, 2016, but then must take a second RMD for 2016 by the end of next year. Missing the deadline for taking any RMD will result in a penalty equal to 50% of the undistributed amount.
  - The RMD rules apply to Traditional IRAs and, in most cases, to employer retirement plans. Roth IRAs, however, are exempt from these rules. Upon death of the owner, any non-spouse beneficiary must also take RMDs, including from a Roth IRA.

Other Financial Planning Considerations

- The annual gift tax exclusion amount remained $14,000 for 2015 (and for 2016). Taxpayers trying to minimize a future estate tax liability can begin by making annual gifts to family members.
- The estate tax exemption amount rose to $5.43 million for 2015 and will increase with inflation each year going forward (the 2016 amount is $5.45 million). Making large gifts under this provision should be done only after a thorough review of the overall estate plan, but should be strongly considered by those who are likely to pay an estate tax.
- Taxpayers may consider funding a 529 plan to help pay for future education expenses. One advantage of gifting to a 529 plan is that 5 years' worth of gifts can be made in one year. With the annual gift exclusion at $14,000 for 2015, a taxpayer can gift up to $70,000 at one time to a 529 plan – double that if the gift comes from a couple. Taxpayers considering making 5 years of gifts at once should wait until early 2016 to do so. That will allow them to still contribute $14,000 to the 529 for 2015 before doing the 2016 through 2020 gifts next year.
- Funding a Coverdell Education Savings Account can also provide tax-free income for education expenses. Taxpayers can contribute up to $2,000 per year per beneficiary under 18 years old. Because Coverdell accounts are the only tax-advantaged vehicle that can be used for K-12 expenses, these accounts are still valuable to many taxpayers. Contributions are limited to married couples with Modified AGI below $220,000 ($110,000 for singles).

Staying Up-To-Date

This may be a good time to address other financial concerns that don't necessarily relate to year-end.

- Investors should review their investment asset allocation with their Baird Financial Advisor to determine if it's still appropriate given their goals and time horizon. Market volatility can also trigger a need to rebalance a portfolio periodically back to a target allocation.
- Individuals should compile a list of where all pertinent financial documents can be found in the event they become incapacitated. Include account numbers, contact names and phone numbers, and other key facts on all family members. This sheet should be kept in a safe location, but accessible by the appropriate person if the need arises.
- Estate documents should be reviewed to ensure they're still appropriate, especially if there has been any change in marital status, any births or deaths in the family, a significant change in personal net worth, or relocation to a new state during the year.
- Review any beneficiary designations on insurance policies, retirement plans, etc. to ensure they are still appropriate.

For more information, please contact your Baird Financial Advisor.

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