Year-End Tax and Financial Planning Ideas

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

Whoever said "Variety is the spice of life" clearly wasn't thinking about tax law. While regular changes to the tax law may be good news for political pundits and CPAs, most taxpayers would prefer a consistent, predictable set of rules from year-to-year. For the first time in what seems like forever, 2014 has given us just that.

Outside of the expiration of a handful of provisions, most of which affect a small percentage of taxpayers, the federal tax code is relatively unchanged from 2013. After the significant slew of changes that took effect last year – new tax rates on ordinary income and capital gains, phaseouts of deductions and exemptions and new health care-related taxes to name a few – taxpayers now understand just what those changes are and how to plan to minimize the impact of the biggest increases. With mid-term elections taking place in November, there may be last minute attempt to push through a variety of changes during the lame duck session that will close out the year. Most of those, however, are expected to be limited to extending provisions that expired at the end of 2013. A newly configured Congress in 2015 may look to tackle the Holy Grail of comprehensive tax reform, but that's a topic for another day.

Having said all that, a consistent tax code doesn't mean taxpayers will have a consistent tax experience. 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 2014 and 2015 – due to job change, retirement, 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.

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

Planning for Capital Gains & Losses

Understanding the tax rate that will apply to a net long-term capital gain became much more complicated with last year's change in rates for high income taxpayers, as well as the Medicare tax on net investment income.

- For 2014, taxpayers in the two lowest tax brackets will continue to enjoy tax-free long-term capital gains. While that doesn't mean low income taxpayers can have an unlimited amount of gains that are tax-free, it does provide a planning opportunity for those taxpayers. If you find yourself in the lower ordinary tax

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brackets for 2014 (taxable income below $73,800 for couples and $36,900 for singles), consider realizing some tax-free gains this year. However, be sure to work with a tax advisor as there are rules limiting the overall benefit.

- Once taxpayers exceed those income levels, their long-term gains will be subject to the same 15% tax rate that has been in place for several years.
- Taxpayers reaching the highest tax bracket are subject to a 20% tax rate on their long-term capital gains. This rate applies for couples with taxable income over $457,600 and singles over $406,750 in 2014.
- Lastly, couples with Modified Adjusted Gross Income (MAGI) above $250,000 this year ($200,000 for singles) will also owe a 3.8% tax on their investment income over those thresholds. Because MAGI is always 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 that were just below the threshold in 2013 may be in for a surprise this year.
- 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 2015 due to retirement, realizing a gain in 2014 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 2015. 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 your 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 your ordinary income tax rate, it's important to plan to offset those first, which may require realizing only short-term losses.
- Conversely, you 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 you have 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.
    - Avoid the urge to recognize gains in order to "use up" losses you realized during the year, only to immediately repurchase the item sold at a gain because you still want to own it. Those losses can be carried forward to the next year, when you may have a gain that is appropriate to

realize from an investment standpoint. You wouldn't want to have to pay tax on a gain next year because you felt the need to "use up" losses this 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:

- Make sure you will have enough interest income and short-term gains to be able to offset any margin interest paid during the year. Margin interest is deductible only against those types of investment income, although excess interest expense may be carried over indefinitely to offset future investment earnings.
    - When dividend income began being taxed the same as long-term capital gains, it no longer qualified as investment income for purposes of this deduction. Taxpayers do have the option of foregoing the lower tax rates on 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 waiting for perhaps a larger benefit at some point 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 as you divest of investments at a loss. These rules prevent you from deducting a capital loss from the sale of an item if you 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. While a loss under the wash sale rule is usually only deferred rather than permanently lost, you would still prefer to get the full tax benefit of any realized losses sooner rather than later.
    - In 2008, the IRS clarified that selling a security for a loss in a taxable account and then repurchasing it in an IRA can trigger the wash sale rule. This had been unclear until the IRS announcement. In this scenario, the loss on the sale is permanently lost. Therefore, be sure to look across your entire portfolio when determining if the wash sale rules will apply to you.
    - Investment firms are required to account for wash sales happening 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", you must be able to prove the stock had value at the end of 2013 but did not at the end of 2014. If you are unsure you can prove that the stock is truly worthless by the end of the year, you will need to sell the stock for whatever value you can in order to deduct a 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

The tax act passed in early 2013 marked the return of the 39.6% tax bracket. 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 2014.

- Review your federal withholding and estimated income tax payments to make sure you will not be subject to underpayment penalties. Even though your 2014 tax liability may have increased over 2013, 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 2014, your total tax payments must equal the lesser of (1) 90% of your current year tax liability or (2) 100% of last year's liability (110% if Adjusted Gross Income (AGI) was more than $150,000 for 2013). For those taxpayers whose 2014 income is the same or higher than it was in 2013, there's a good chance they can wait to pay the increased tax until they file their 2014 tax return in April 2015.
    - Taxpayers whose income in 2014 is lower than it was last year may instead prefer to remit just 90% of their projected 2014 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 your federal tax payments until April 15. Keep in mind that requesting an extension of time to file your tax return doesn't extend the time for paying your taxes.
- 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, if you retired in 2014, or plan to in 2015, your decreased income could cause you to fall to a lower bracket next year, and that bracket could have a lower marginal tax rate. If that's true, you may find that deferring other income into 2015 from 2014 will 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.
- With more states recognizing same-sex marriages, many taxpayers may be filing joint tax returns in 2014 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 – of same or opposite sex – should be prepared for this potential tax increase.
    - 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.

- Last year marked the return of the phaseout of itemized deductions. In 2014, couples with AGI over $305,050 (singles over $254,200) 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 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 2014 or after.
    - For taxpayers whose income will increase in 2015, 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 2015, it may make sense to accelerate deductions into 2014.
    - Another factor is whether or not you may be subject to AMT in either year. Taxpayers subject to that extra tax 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. 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 2014. 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.
- The law that allows eligible taxpayers to make donations directly from their IRA (known as a Qualified Charitable Distribution, or QCD) and not have to report the withdrawal as income expired at the end of

2013. 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. When this rule was last extended after expiring, it was only made retroactive for one month, not back to the beginning of the year.
  - Even if the QCD rule is not extended beyond 2013, taxpayers can still gift an IRA withdrawal 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.

- 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 last year.
- On the topic of medical expenses – 2014 is the first year that taxpayers are required to purchase health care coverage under the 2010 health care act. The penalty for not purchasing coverage is the greater of 1% of income or a flat $95 for a single person, $285 for a family. The penalty is calculated on a monthly basis, meaning purchasing coverage now won't allow you to avoid the penalty, but it can minimize it. For 2015, the penalty increases to 2% of income or a flat rate of $975. There are numerous exceptions to the penalty, so check with a tax advisor to determine your requirements under this rule.
- Like with itemized deductions, personal exemptions – the $3,950 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).
- If you have employer stock options, review your long-term strategy to determine whether you should exercise any options this year. This is particularly true if you hold Incentive Stock Options (ISOs). While these options only create income for Alternative Minimum Tax purposes, that can still lead 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 recognize income before year-end.
- The Kiddie Tax expanded in 2008 to children under age 19, or under age 24 if they are a full-time student. Parents should keep this tax in mind as they structure gifting and investment strategies for 2013 and beyond.

Retirement Planning

- Be sure to maximize 401(k) or other retirement plan contributions for which you are eligible.
- Review contributing to a Traditional Individual Retirement Account (IRA) or Roth IRA. Contributions to these accounts are limited to a combined $5,500 ($6,500 if age 50 or over) for 2014.
  - With a Traditional IRA, income limits affect the ability to deduct the contribution if you're covered by an employer–sponsored plan. For 2014, married couples with income over $96,000 and singles over $60,000 will begin to lose the benefit of the IRA deduction. The deduction is fully phased out once income reaches $116,000 for couples, $70,000 for singles. However, being over that threshold does not prevent you from making a non-deductible contribution (as long as you have earned income equal or greater to the contribution amount).
  - With a Roth IRA, you can contribute only if your AGI is no more than $181,000 for joint taxpayers ($114,000 for single taxpayers), with contributions phased out at $191,000 ($129,000 for singles).
- Consider converting a Traditional IRA to a Roth IRA prior to year-end. Remember that in 2010, the AGI limit for Roth conversions was permanently eliminated. While all taxpayers are now eligible to do a conversion, it 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. If that's the case, you 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 2013, the deadline to recharacterize the Roth conversion was October 15, 2014. However, conversions done in 2014 may be recharacterized until October 15, 2015.
  - If you do recharacterize back to a Traditional IRA, you can then re-convert it back to a Roth IRA, subject to waiting periods. You must wait until the next taxable year after the original conversion to the Roth, or 30 days, whichever is longer. This means that if you recharacterized a 2013 Roth conversion during 2014, you can then reconvert it back to a Roth during 2014, as long as you wait 30 days. If the original conversion was in 2014 and you recharacterized it this year, then you must wait until at least January 1, 2015 to reconvert back to a Roth.
- If you are over age 70½, you are subject to the Required Minimum Distribution (RMD) rules and must take a distribution from your IRA by December 31, 2014. If you turned 70½ during 2014, your first RMD can be deferred until April 1, 2015, but you will have to take a second RMD for 2015 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.

Other Financial Planning Considerations

- The annual gift tax exclusion amount remained $14,000 for 2014. 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 $5.34 million for 2014 and will increase with inflation each year going forward. Making large gifts under this provision should be done only after a thorough review of your overall estate plan, but should be strongly considered by those who are likely to pay an estate tax.
- Establishing a Coverdell Education Savings Account can 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).
- Taxpayers may also consider funding a 529 plan 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 2014, 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 2015 to do so. That will allow them to still contribute $14,000 to the 529 for 2014 before doing the 2015 through 2019 gifts next year.

Staying Up-To-Date

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

- Review your investment asset allocation with your Baird Financial Advisor to determine if it is still appropriate given your goals and time horizon.
- Compile a list of where all your pertinent financial documents can be found in the event you become incapacitated. Include account numbers, contact names and phone numbers, and other key facts on you, your family and your assets. This sheet should be kept in a safe location, but accessible by the appropriate person if the need arises.
- Make sure your estate documents are still appropriate, especially if you've had any change in your marital status, any births or deaths in the family, a significant change in your personal net worth, or moved 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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