Investment Planning Tips for Individuals

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This newsletter provides you with suggestions for managing your investments while reviewing the tax implications. As you consider them, don't overlook the fact that the goal of tax planning should be limited to achieving your personal and business financial goals in a "tax efficient" manner. In other words, it doesn't make sense to focus simply on the tax savings from a transaction. The real issue is whether you're better off on an after-tax basis (for this year and beyond) than you were before implementing the tax planning idea.

Tax Efficient Moves for Your Investments.

Has the continued turbulence in the stock market got you thinking that it's time to make a few changes in your portfolio? If so, here are some moves you should consider to minimize the tax impact of any changes.

Carefully choose how you rebalance your portfolio.

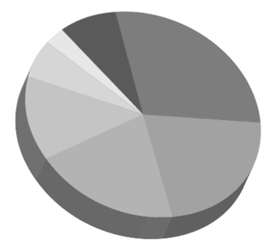
Perhaps you decided a year or two ago that your risk tolerance and investment needs called for a portfolio of 65% stocks, 25% bonds, and 10% cash or money market funds. But, because of market fluctuations, your portfolio is currently out of sync with your objective.

If you're like most investors, you probably have some investments in taxable accounts and some inside of IRAs, 401(k)s, etc. Thus, as you're rebalancing your portfolio, to the extent possible try to (1) limit sales of appreciated stocks and funds to those held inside of tax sheltered accounts and (2) sell assets that have dropped in value from your taxable accounts (so that as much of the loss as possible will be deductible). Then reinvest the proceeds to get back to a ratio of stocks, bonds, and cash with which you're comfortable.

Another way to rebalance without triggering tax consequences has to do with future investments. For example, if you're regularly reinvesting dividends or adding new money to the accounts, you may be able to tax – efficiently rebalance your investments simply by redirecting your dividends and the "new" money to the asset categories that are currently underweighted in your portfolio.

Harvest your losses when repositioning your portfolio.

The maximum possible tax rate on long-term capital gains in 2015 continues to be 23.8%. Therefore it is still a good time to take advantage of reshuffling your portfolio. Let's assume that the reshuffling process involves selling some winners (current market value above what you paid). The tax-saving strategy is to flow up by selling enough losers (currently worth less than you paid) to fully offset the gains from the winners.



Result: You owe zero to Uncle Sam.

But why stop there? You can continue trimming more losers from your portfolio until you've generated a $3,000 net capital loss for the year ($1,500 net loss if you're married, but file separately from your spouse this year). You can then deduct that $3,000 loss against taxable income earned from any other source (salary, self-employment activities, interest, dividends, alimony, etc.).

If your harvesting activity triggers a net capital loss above the deductible limit ($3,000 or $1,500), you are allowed to carry over the excess losses. You can then use the carryover loss to either shelter future capital gains or income from other sources, according to the rules just explained.

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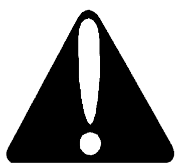
But what if you already have a large net capital loss from your year-to-date sales? In this situation, consider selling just enough winners to climb back up to that magic negative $3,000 (or $1,500) level. Locking in those gains by selling the securities won't add anything to your tax bill.

Beware of rising interest rates

Right now might be the perfect time to shuffle your portfolio too. As the Fed dials back on its bond buying program, and interest rates begin to return to normal levels, it may be time to pull out of certain sectors. Look out for securities like utility stocks, consumer staples, or other steady dividend companies. These are all defensive positions people tend to move portions of their portfolio to during times of uncertainty and low interest rates. However as the economy improves and interest rates rise, money will start to leave these areas for bonds, CDs, and riskier securities. Meaning, it could be just the right time to sell.



Warning: Beware of the wash-sale rule when considering sales to trigger tax losses. You cannot deduct the loss if you purchase substantially identical securities within the period beginning 30 days before and ending 30 days after the date of the loss sale.

Use "Specific ID Method" to further minimize taxes.

Say you want to unload only some of your shares in a particular company or mutual fund. For example, you might want to sell part of your Apple holdings, while still hanging onto a reduced stock. If you acquired the Apple shares at various times for various prices, your tax-savings objective here is to sell the highest-cost shares first. That way, you'll trigger the lowest possible capital gain or the biggest possible capital loss.

Under the so-called "Specific ID method," you can select the particular shares you wish to sell (the highest-cost ones). To take advantage of this tax-saving method if your securities are held by your broker, IRS regulations say you must notify your broker regarding which shares you want to sell and identify them by reference to their purchase date and per-share price. The broker must then issue you a written confirmation of your instructions.

Unfortunately, discount and on-line brokers may be unwilling or unable to issue these confirmations. In this scenario, the Tax Court's 1994 *Concord Instruments Corp.* decision seems to say you can give oral instructions regarding which shares to sell and still use the "Specific ID method" even though no confirmation is forthcoming. However, you should carefully document your instructions by making notations on the written transaction statements received from your Broker (and it is still better to follow the requirements under the IRS regulations when possible).

Select the correct account for each type of investment.

If you regularly trade stocks or frequently switch in and out of mutual funds, you're better off doing this through a retirement account (such as a self-directed IRA) so that any gains are not currently taxed. In addition, if you have identical positions in a retirement account and a taxable account and want to cut back on a losing position, consider liquidating the investment in the taxable account so that the loss can offset any taxable gains, plus up to $3,000 of ordinary income ($1,500 on a married filing separately return).

If you're a "buy and hold" kind of investor who likes both mutual funds and individual stocks, it's generally more beneficial to do your mutual fund investing through retirement accounts and to buy the individual stocks in a taxable account. You control when the stocks are sold, but mutual funds tend to distribute taxable dividends annually even though you must be in the fund for the long haul. Ignoring the non-tax issues involved, if all you own is mutual funds, then those that track a market index or are otherwise managed to be tax efficient (meaning they try to offset gains and losses) will generally work best for your taxable account.

Sell losers and gift the cash; but give winners away.

Say you want to make some gifts to your favorite relatives or charities. In fact, you can make these gifts in conjunction with your overall program of reducing the amount invested in stocks. Here's how to get the best tax results from your generosity.

First, *don't* give away loser stocks (currently worth less than what you paid) as a gift to a relative. Instead sell the shares and take advantage of the resulting capital loss to shelter your capital gains or income from other sources, as explained above. Then give cash to your relative. Since you just sold the stock, you'll have the cash in hand.

Second, *do* give away appreciated shares to children or grandchildren who are in the 10% or 15% tax bracket. When they sell, the resulting gains could be taxed at a rate as low as 0%, provided you and the gift recipient have together owned the stock over a year. Even if the shares have been held for only one year or less, the gift recipient will still pay at most a 15% tax on the gain. That's still a pretty good rate. In contrast, if you sell appreciated stock yourself, you'll probably pay 15% or more on any long-term gains. Short-term gains will be taxed at your regular rate, which can be as high as 39.6% this year.

However, watch out for one thing before you employ this give-away-appreciated-stock strategy. Gains recognized by children under age 18 may be taxed at their parents' marginal rates under the so-called Kiddie Tax rules. Usually that means the child will pay more than the mere 5%, 10%, or 15% rate you expected when you made the gift.

Fortunately, the Kiddie Tax doesn't apply the year a child turns 19 (or any years thereafter), as well as for dependent, full-time students over the age of 24. Also, the Kiddie Tax only affects children with over $2,100 of "unearned income" from capital gains, interest, dividends, and the like.

There are a couple of additional caveats with this planning idea. First, each year up to $14,000 of assets (or up to $28,000 if your spouse joins in the gift) can be given to anyone without creating a potential gift tax liability. If the value of the shares you plan to give exceeds this limit, you may want to consider other options for transferring the funds.

Secondly, when children expect to receive financial aid for college expenses, having them sell the securities may be counterproductive. To qualify for aid, colleges require a much higher portion of a student's assets and income to be used for college expenses compared to what is required of parents (and, of course, nothing is required of grandparents). Thus, moving assets from yourself to the child could cost you more in lost financial aid than it saves in taxes.

Now let's talk about charitable donations.

It turns out the strategies for gifts to relatives work equally well for gifts to charities. So, sell loser shares and claim the resulting tax-saving capital losses on your return (subject to the loss deduction limits discussed earlier). Then, give cash to the charity and claim the resulting charitable write-off. As you can see, this idea results in a double tax benefit for you.

As for winner stocks, give them away to charity instead of donating cash. Here's why. For publicly traded shares you've owned for more than one year, you're allowed to claim a charitable deduction for the full current market value. Plus, when you give the appreciated stock away, you get rid of the "built-in" capital gains tax liability. So this idea is also a double tax-saver for you. Because the charitable organization is tax-exempt, it can sell your donated shares without owing anything to Uncle Sam. Truly, this is a win-win situation for everybody except the IRS.

Don't forget holding period rule for qualified dividends.

Qualified dividends are now taxed at not more than 20%. However, don't forget you must satisfy a holding period rule to be eligible for low rates. Specifically, the shareholder must hold the stock on which the dividend is paid for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date (the day following the last day on which shareholders of record are entitled to receive the upcoming dividend payment). When this holding period rule is not met, dividends are taxed at ordinary income rates.

Note that a stricter holding period rule applies to preferred stock dividends that are attributable to periods aggregating in excess of 367 days. In this circumstance, the shareholder must hold the preferred stock on which the dividend is paid for more than 90 days during the 181-day period that begins 90 days before the ex-dividend date in order to qualify for the reduced rates.

Finally, watch out for "preferred stock dividends" that are not really dividends at all. Some "preferred stock" issues are actually nothing more than publicly traded wrappers around batches of corporate bonds. "Dividends" paid on these issues are really interest and are, therefore, taxed at ordinary income rates.

Watch out for mutual fund acquisitions near year-end.

As you may know, taxable mutual fund dividend distributions generally occur near the end of the calendar year. Individuals who invest in mutual funds via taxable accounts should generally avoid buying into a fund right before the ex-dividend date for a significant capital gains distribution. Those who ignore this advice can get stuck with a big taxable income hit from gains that accrued before their shares were acquired. In effect, these folks unwittingly buy into a tax liability when they buy into the fund.

Tax Exempt Securities.

Individuals in higher tax brackets often consider tax-exempt municipal bonds an attractive investment. Interest earned on municipal bonds is generally free of federal income taxes and, usually, state income taxes in the issuing state. In general, tax-exempt bonds pay investors less interest than comparable bonds paying taxable interest. The higher your tax rate, the more a taxable bond has to pay you to match the return of a tax-exempt bond.

PLANNING IDEAS FOR YOUR IRAS AND OTHER RETIREMENT ACCOUNTS

Plan ahead for age 70½.

If you (or a close relative) will reach age 70½ within the next couple of years, you have some important decisions to make regarding any traditional IRAs that you own. On April 1 of the year *after* you turn 70½, the choices you've made regarding the accounts' beneficiaries and the method(s) of determining your (and if applicable, your spouse's) life expectancy become fixed. You can change beneficiaries at a later date, but unless the new beneficiary is older, any change won't affect the minimum amount you're required to begin taking from the accounts.

Thus, it's important to verify with the IRAs' trustees that you've made the appropriate choices. You also have some flexibility on when you take your first required distribution from your traditional IRAs, so you'll want to carefully consider these options as well.

Think twice about rolling over employer securities from a retirement plan.

If you're like many employees, a significant part of your retirement plan balance is in employer stock. If you receive a distribution of this stock, the normal assumption is that you should roll it into an IRA to avoid paying tax on the distribution. However, if the stock has a relatively low basis it may make sense to keep it out of the plan. By doing this, you'll pay tax (and, if you're under age 59½, a potential 10% early distribution penalty) on the plan's cost basis for the stock. However, the difference between this basis and the stock's value isn't taxed until the stock is sold. Then, it's normally subject only to the 15% (or more depending on income) long-term capital gains rate rather than the ordinary income rates (of up to 39.6%) that would apply if the stock were rolled over, sold inside the IRA, and the proceeds distributed at some point in the future. In addition, by not rolling over the stock, you'll reduce the amount of the required distributions you'll be required to take from your IRAs once you reach age 70½.

Encourage your children or grandchildren to set up a Roth IRA.

If your kids or grandkids are just entering the work force, one of the best things you can do is to teach them the value of saving with a Roth IRA. For example, someone with at least $2,000 of earned income who puts $2,000 a year into a Roth IRA for only 10 years beginning at age 16 (perhaps because you give them the funds) will accumulate over $1.3 million of tax free dollars by the time they're age 65, assuming a constant 10% earnings rate.

If they're lucky enough to earn 12% annually, they'd have almost $3 million of tax-free dollars from just $20,000 of Roth IRA contributions.

Alternative Minimum Tax Planning (AMT).

Any planning for the rest of this year and beyond should include a thorough review of the potential impact of the Alternative Minimum Tax (AMT). Although designed to limit the ability of higher income tax payers to reduce their taxes through the use of "loopholes," the AMT will continue to affect the taxes of a dramatically increasing number of unsuspecting middle-class or upper middle-class taxpayers in the next few years Thus, the AMT deserves consideration when evaluating any tax planning strategy. We can help you plan for, and possibly reduce or eliminate, an AMT liability.

OUR INVESTING PHILOSOPHY

Some thoughts with respect to our philosophy when it comes to your investments.

- All investors are unique, with different goals and risk tolerance.
- Investing is for long-term financial goals; saving is for meeting short-term goals.
- Broad diversification, with exposure to all parts of the stock and bond markets, reduces risk.
- An investor's more important decision is selecting the mix of assets to be held in a portfolio, not selecting the individual investments themselves.
- Outperforming the financial markets is extremely difficult.
- Minimizing the tax impact of investing is vital for long-term investment success.
- Investors should know how each investment fits into their plans and why they own that particular asset.
- Risk has many dimensions, and investors should weigh "shortfall risk" - the possibility that a portfolio will fail to meet longer-term financial goals - against "market risks," or the chance that returns will fluctuate.
- Market-timing and performance-chasing are losing strategies.

Prior to addressing your asset allocation, you should have a full financial plan prepared. All assets, including those in your retirement accounts, should be summarized and reviewed. With the multitude of investment options out there, it is more important than ever to get a sense of how your investments are really allocated.

Conclusion. This newsletter is intended to give you a ideas for your individual tax planning. Please note, this is general year-round planning advice.

Contact us to schedule a strategy session with one of our tax and financial planning professionals.

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