STRATEGIC INCOME TAX PLANNING

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STRATEGIES TO IMPROVE A FAMILY'S TAX RETURN OUTCOME

As investment executives who specialize in helping our clients meet their financial goals, we understand that you may have questions about the areas you need to focus on during this phase in your life. This special report presents a list of strategies and missed opportunities out there to improve a family's tax return outcome.

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STRATEGIC TAX PLANNING: YOU GOT THIS!

Morgan Stanley ran an ad that said: "You must pay taxes. But there's no law that says you gotta leave a tip." The tax code is ridiculously complex. Every time Congress makes a change, I am guaranteed employment for another five years. Despite its complexity, the long-term tax planning goals are rather simple. First, find ways to reduce your income. Second, find ways to increase deductions. Third, find ways to increase credits. My goal in this paper is to review some of the strategies that I use with my clients and to highlight some of the missed opportunities out there to improve a family's tax return outcome.

Pat yourself on the back because you are taking the first step to learning more about taxes.

1. REDUCE YOUR INCOME

TAX LOSS HARVESTING:

If you have a taxable account (personal, joint, or trust), then each year you should consider selling any position that is at a loss. My firm uses a 5 & 5 rule. If a position has a loss of at least $5K and it exceeds 5% of the position's value, then we will sell it to lock in the loss. The reason the 5% is included is because we don't want to disturb a $200K position that only has a loss of $5K. We view this as too large of a trade for too little of a benefit. The losses that we accumulate can be used to offset other gains that we take within the portfolio throughout the year. If we end up with more losses than gains, we are allowed to use up to $3K of these excess losses to offset other forms of income (including wages) and any remaining losses we can, carried forward to next year. Losses never expire during your lifetime, however, they do disappear when you pass.

PHILANTHROPY – QUALIFIED CHARITABLE DISTRIBUTIONS:

If you are over the age of 70.5, you are required to take minimum distributions from your retirement account (RMD). These distributions are usually fully taxable and must be reported as income on your income tax return. If you are charitably-inclined, then you may want to consider donating some, or all, of your RMD (up to $100K) directly from your IRA to a qualifying charity as a qualified charitable distribution (QCD).

This will reduce, or possibly eliminate, the need to report the distribution as taxable income, helping to reduce your AGI along the way. AGI impacts a number of other areas within your tax return such as: itemized deduction phase-outs, exemption phase-outs, Roth contribution eligibility, the net investment income Medicare surtax, Medicare premium costs, the taxability of Social Security income, and some credit phase-outs.[1]

SOLO 401K PLAN:

If you run an owner-only business, with no employees, and work over 1,000 hours a year (with the exception of your spouse), then you should take a look at solo 401k plans. Not only are you allowed to make employee contributions up to $18K, plus a $6K catchup (for those over age 50), but you can also make an employer profit sharing contribution of up to 25% of your income (20% net income for unincorporated businesses). The maximum contribution for 2017 is $54K ($60K if over age 50).

The other type of retirement plan that is often used for owner-only businesses is the SEP IRA account. A SEP IRA only allows for employer profit sharing contributions. To give you a sense just how much more you can contribute to a solo 401k versus a SEP IRA, let's look at an example.

A 55 year old small business owner (unincorporated) earning $100K net of expenses can contribute $18,587 into a SEP IRA or $42,587 into a solo 401k. Once your solo 401k plan exceeds $250K in assets, you are required to file Form 5500EZ. Form 5500EZ also needs to be filed when the 401k plan is eventually terminated, even if the assets never exceeded $250K.[2]

One final note, you need to open a solo 401k plan before December 31st in order to contribute for that year. Contributions do not need to be made until you file your taxes (including extensions).

DELAY CLAIMING SOCIAL SECURITY BENEFITS:

Every year that you delay claiming Social Security benefits, the monthly benefit increases by 7%-8%. Up to 85% of your Social Security benefit needs to be reported on your income tax return. The remaining 15% does not need to be reported and therefore, represents tax-free income. This means that the larger your Social Security benefit is, the larger the amount of tax-free income you can receive. The table below is an example highlighting this benefit at age 62, 66 and 70.

Age	Mo. Benefit	Annual Benefit	85% Taxable	15% Tax Free
62	$1,500	$18,000	$15,300	$2,700
66	$2,000	$24,000	$20,400	$3,600
70	$2,640	$31,680	$26,928	$4,752

2. INCREASE YOUR DEDUCTIONS

PHILANTHROPY – HIGHLY APPRECIATED STOCK:

Within a taxable account (non-retirement), if you paid $100K for Apple stock and it is currently worth $500K, then most people would describe the value of Apple stock as $500K. However, taxes have not been paid yet, which clearly reduces the value. If you sell the stock, you could owe federal taxes at a rate as high as 23.8%. This means the real value is actually closer to about $400K. If you and your family plan to donate money to charity, consider donating appreciated stock instead. If you donated your entire Apple position, the charity can receive the stock, liquidate it, and keep the full $500K because charities do not pay taxes. You also get to write-off the full $500K on your taxes because you donated the stock as opposed to selling it first, paying the taxes, and giving the charity the after-tax amount. This is a win-win for both parties.

3. INCREASE YOUR CREDITS

- Have more kids ☺
- Consider energy credits

4. INCREASE YOUR INCOME… WHAT?

MEDICAL EXPENSES & IRA DISTRIBUTIONS:

If you experience high medical expenses, then you want to make sure that you have the taxable income necessary to use all of the medical expense deductions. Unused medical expense deductions do *NOT* carry-forward. It is "use it, or lose it." IRA distributions are usually fully taxable and therefore, offer a quick and easy way to increase your taxable income. If you need funds to help cover these medical expenses, then taking withdrawals from the IRA will provide resources to cover these fees. If you have plenty of non-retirement assets to cover your medical expenses, then you may want to consider doing an IRA to Roth conversion. This would allow you to use up the deduction while transferring the assets to a more favorable account going forward.

IRA TO ROTH CONVERSION:

IRA to Roth conversions, I think, are a missed opportunity for many families. When you expect your tax liability to be higher in future years, then you may want to take a look at IRA to Roth Conversions. A common example of this is after someone retires, but before they turn 70.5 when required minimum distributions (RMD) begin. During these years, we find that many family's effective tax rates fall substantially. Provided that there are sufficient non-retirement assets to cover the taxes, it usually makes sense to begin converting IRA assets to a Roth account. This will push the family's effective tax rate higher for the years that conversions take place, however, once RMDs begin, we find that we were able to lower the effective rate compared to not doing any conversions. As long as you live long enough to recover the taxes you paid as a result of the conversions, then not only can you save a lot in taxes over a lifetime, but you can also pass onto your loved ones the best type of account to inherit (i.e. Roth).

5. I'LL BET YOU DIDN'T KNOW

MASSACHUSETTS SHORT-TERM CAPITAL GAINS RATE:

When you hold an investment for greater than 12 months before selling it, then it will be considered a long-term capital gain, and the profit will be taxed at a rate of 5.10% in Massachusetts. When you sell the investment within the 12 month period, it will be considered a short-term capital gain and will be taxed at a 12% rate in Massachusetts.[3]

Be sure to pay attention to these holding periods, and when possible, try to meet the long-term capital gain status. Your wallet/purse will thank you.

IRA CONTRIBUTIONS:

Massachusetts is one of the few states that does *NOT* offer a deduction on your state income tax return for any IRA contributions that you make. The federal government does allow for a deduction provided you meet certain criteria. This means that you can have pre-tax funds in an IRA from the federal government's point of view, and after-tax funds from the state of Massachusetts' point of view. It is important to track the after-tax contributions so that when you start taking distributions you "recover" these after-tax funds and do not pay taxes twice on the same dollars.

What makes this unique is that all other "deductible/non-reportable" retirement plan contributions do get a tax break in Massachusetts. It is just IRA contributions that are treated differently.

CAPITAL GAINS DISTRIBUTIONS:

A mutual fund is a pool of money within which securities are bought and sold. Shareholders are ultimately responsible for any net profits that are realized within the fund. This is the reason that funds pay out capital gain distributions at year-end to shareholders so that the shareholder will pick up the tax liability on their own personal return (provided the fund is held in a taxable account). Irrespective of whether you collect the distribution in the form of cash, or if you reinvest it into buying more shares, the tax treatment is the same.

Most of these capital gain distributions are paid around year-end. Investors should inquire with the fund company to see if estimated capital gain distributions have been identified yet. If so, just realize that there is a possibility that most, or all, of the profits came before you were a shareholder. This may result in you sharing in the tax liability without having participated in the nice run the fund experienced.

Let's look at an example:

- John and Sarah buy 1,000 shares of XYZ mutual fund on 11/1/2016 at $11.00/share. This means they spent $11,000.
- On 12/1/2016, the fund projected that the capital gain distribution would be $0.50/share payable at year-end.
- John and Sarah own 1,000 shares, so they will receive a distribution totaling $500. This will result in a tax liability of approximately $100 (federal and state of MA).
- If the price of XYZ was $11.00 share just prior to the distribution, the price will drop to $10.50 right after the distribution is earned.
- So now, the $11,000 position just dropped to $10,500, in exchange for receiving a $500 distribution, of which $100 will need to go to taxes.
- New value: $10,500 + $400 = $10,900.
    - $100 loss because we bought right before the distribution.

SUMMARY

We hope that you found this whitepaper on Strategic Tax Income Planning to be helpful and informative. Please remember that nothing referenced in this paper should be construed as legal or accounting advice. Legal or accounting advice should only come from a qualified attorney or accountant.

If you would like to discuss your personal financial situation, please do not hesitate to give our office a call at (978) 624-3000. We would be happy to talk to you.

Sincerely,

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[1] Marotta, D. J. (2016, April 28). Qualified Charitable Distributions (QCDs) from IRAs. Retrieved December 27, 2017, from https://www.forbes.com/sites/davidmarotta/2016/04/28/qualified-charitable-distributions-qcds-from-iras/#3af3e5ed41f1

[2] Nolan, M. (2014, November 12). Process for Terminating or Closing a Solo 401k | Solo K | Individual 401k | Individual K. Retrieved December 27, 2017, from https://www.mysolo401k.net/process-terminating-closing-solo-401k-solo-k-individual-401k-individual-k/

[3] Tax Rates. (n.d.). Retrieved December 27, 2017, from https://www.mass.gov/service-details/tax-rates