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Tax-Time Lessons Learned: Things Taxpayers Wish They Had Done Last Year

In many ways preparing a federal income-tax return is like taking a final exam in a class. The tax return is tangible evidence of how effective a taxpayer's planning was in the prior year.

Tax time presents a great opportunity for professional advisors to help their clients identify opportunities they might have missed the previous year and create strategies to capitalize on those opportunities this year. These are real opportunities for taxpayers to position themselves for better results moving forward. As advisors know, even though it seems like a long time before preparation of 2016 federal income-tax returns begin, there is no better time than the present to start planning.

In this issue of *Financial Strategies* we look at some of the most common ways donors miss opportunities to produce better tax results. Many of the best strategies are related to creative charitable planning, and we will give particular attention to several of those.

IRA Charitable Rollover Made Permanent

Congress passed and on December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes (PATH) Act of 2015. Part of this major spending bill permanently allows taxpayers who are aged 70½ or older at the time of transfer to make distributions of up to $100,000 per taxpayer per year directly from IRA accounts to qualifying charities without having the amount of the distributions included in taxable income. Consistent with prior law, these IRA charitable rollovers can count toward the taxpayers' required minimum distributions.

Even though PATH was passed late in the year, taxpayers who made distributions directly from IRA accounts to charity prior to the end of 2015 anticipating the potential extension of the law would still be able to treat those transfers as qualifying distributions.

In addition to making the IRA rollover permanent, the charitable community has been advocating for provisions to increase the amount of the maximum qualifying charitable distribution and to expand the law to include life-income gifts such as charitable gift annuities or charitable remainder trusts by even younger donors. PATH did not contain such provisions, and the charitable community will likely continue to seek future changes.

Common Taxpayer Mistakes

Ill-Advised Timing of Securities Transactions. Most would agree that choosing the right asset is the most important aspect of good investing. A close second, though, is timing—buying and selling at the right time.

Of course, we all want to buy low and sell high. Experience has also taught us that doing so is not necessarily as easy as it sounds, despite our best study and research. And there are often other factors that drive when we buy and when we sell.

Making ill-advised decisions about the timing of securities transactions is one of the most common ways taxpayers suboptimize their tax pictures. The good news is that with your guidance some relatively minor tweaking in timing can make big differences from a tax standpoint.

Many taxpayers seem to either not know or fail to consider whether a particular transaction will be deemed to be long-term or short term—a distinction that can, of course, have major tax implications. One reason for this is that many taxpayers tend to react more to external factors, particularly when it comes to selling decisions. It is likely they would be surprised by how much difference that can make.

> **Example**—Joe, who is in the 39.6% tax bracket, bought shares of XYZ Inc. in January of 2015 for $50,000 and sold them for $100,000 in December. Because he had not held the shares for more than one year, his $50,000 gain is short-term and potentially subject to tax at 39.6%—his regular marginal income-tax bracket.

At times there are compelling reasons to sell immediately. However, situations like this create a perfect opportunity to help taxpayers understand potential unintended consequences of their decisions to sell. In the example above, had Joe waited just a short time into early 2016 to sell, he would have established a holding period of more than one year and his gain would have been long-term and taxed at just 20%. Plus, any gain he did realize would have been delayed one more tax year. This reinforces the importance of consulting advisors before acting.

Charitable-Planning Option— Once investment assets have been held long enough to become long-term capital-gain property, they become powerful charitable-planning tools. **Reason:** In most cases a donor can give long-term appreciated property to charity and claim a deduction based on the full fair-market value of the asset without having to recognize any of the appreciation as a taxable gain.

Tax time is a wonderful opportunity to talk with those you advise on how they fund their charitable giving. Those who funded their charitable giving with cash last year will want to consider giving appreciated stock or other long-term capital-gain property this year. Start now to assist them in analyzing their holdings to see which assets might be the best candidates to fund charitable gifts this year.

Typically, the most highly appreciated asset is the best to fund a charitable gift because the donor will avoid tax on the largest amount of appreciation. Some taxpayers may be reluctant to give highly appreciated stock if they are still bullish on the stock's prospects and expect it to continue to go up.

They will appreciate knowing that it may still make sense to give such a stock and simply buy a like number of shares to replace it. This strategy allows them to get all of the advantages of gifts of appreciated property and also lets them establish a new, higher basis in the stock. If the stock does continue to go up in value, future taxable gain will be less when they do sell due to the new higher basis. It is important for them to know, too, that their holding period starts over again; if they sell the newly purchased shares before more than a year has passed, any capital gain they realize would be short-term.

Not Everything Goes Up. Some investments, of course, decline in value. While none of us hopes for this kind of a result, such assets do present planning opportunities.

While some taxpayers sell too soon, others fail to take action when they should. They may not even be aware they have carried into the new year losing investments that could have been sold to generate capital loss to offset other realized gain—and if that loss exceeds total gain, it could be used to offset up to $3,000 of ordinary income.

Taxpayers will be glad to know that they can exercise some control over their taxable income by monitoring investments to determine when assets should be sold. If you encourage them to start now to identify holdings that are under water, they will be poised to make tax-saving decisions near the end of the year.

Charitable-Planning Option— Taxpayers with charitable objectives who missed the chance last year to secure the benefits of selling to realize a loss will want to be vigilant this year for such opportunities. If they sell and realize a loss, they can use the cash proceeds of the sale to fund charitable giving this year. You will want to help them avoid a pitfall a few donors make: giving depreciated securities. The gift is still deductible at full fair-market value, but they may not realize that they cannot claim the paper loss.

Another point at which some donors can get tripped up relates to replacing stock that they have sold. Some sell to capture gain but then jump back in too quickly to repurchase the same shares, thinking the future looks bright for that particular issue. Anyone thinking of doing this will appreciate guidance steering them away from repurchasing within 30 days of the sale and effectively nullifying the loss they hoped to capture by the sale. They should also be glad to know that if they do buy back in and the investment does appreciate, they can shelter any subsequent gain by using the property to fund future charitable gifts.

Itemized Deductions: Living at the Brink

Internal Revenue Service statistics show that fewer than one-third of taxpayers itemize their deductions for federal income-tax purposes. If you advise philanthropically motivated taxpayers who do not itemize, chances are good you can help many of them gain the benefits of itemizing with some simple adjustments in their charitable giving patterns. Even those who do itemize may realize increased benefits by using similar strategies.

Many taxpayers would be surprised to learn that two donors with identical annual incomes and charitable-giving totals over a two-year period could have very different tax bills. One donor might choose to give an equal amount both years while the other decides to make all charitable gifts in one of the tax years and then skip the other. A donor whose deductions fall just below the amount of the standard deduction will be grateful to learn the benefits of "bunching" deductions.

Example—In 2015 the standard deduction for married couples filing jointly was $12,600. When Susan and Phil H, both aged 63, added up their deductions, the total came to $12,000, including their usual $6,000 of charitable gifts. As such, they decided to use the standard deduction.

This year they have decided to give $12,000 and skip next year. Their additional giving this year will enable them to itemize and get additional tax savings from some of their giving. Next year they will make no gifts but will still be able to take the standard deduction.

Bonus for Itemizers. Don't overlook the potential for those who do itemize to benefit from the same kind of multi-year strategy. If a donor's total amount of itemized deductions exceeds the standard deduction amount by less than the amount of the taxpayer's charitable gifts, that taxpayer would benefit from doubling up gifts and giving every other year. For instance, in the example above assume Susan and Phil's itemized expenses exceeded the standard deduction by just $1,000 each year. If they continue their normal pattern of giving $6,000 annually, they will benefit from $2,000 of deductions beyond the standard deduction this year and next year—$1,000 each year. However, if they double up their gifts this year and skip next year, they will benefit from $7,000 of deductions beyond the standard deduction over the two years—$7,000 this year and then no additional deduction next year when they use the standard deduction. Net result: $5,000 of additional deductions over the two years, which could save as much as $1,980 in federal income tax.

Maximizing Retirement-Savings Options

Many taxpayers don't realize until they prepare their tax returns that they could have capitalized on tax-advantaged retirement-savings options. A review at tax time helps advisors point out additional opportunities that many taxpayers miss—such as the chance to leverage matching contributions to a 401(k) or 403(b) plan from an employer.

Still others genuinely believe they have availed themselves of all the options. A tax-time review is an excellent time to introduce them to options they may not have considered that give them a second chance at tax-favored retirement savings. For instance, they may not realize that qualifying taxpayers generally have until the due date of the return plus any extensions to make contributions to some plans, such as a regular or Roth IRA or a SEP IRA—as long as the contribution is made before the taxpayer actually files the return in a timely fashion.

Expand the Possibilities with Creative Charitable Planning. This is also an opportunity to introduce them to additional options available only to those with significant charitable objectives. Donors are typically delighted to learn that there are multiple ways they can make a gift now, benefit from tax savings from current deductions, generate additional income in retirement, and support the missions of their favorite charities.

Example—Mark W, 55, is a successful professional who utilizes all traditional retirement-planning options but would still like to do more to secure his retirement. He is also a generous supporter of his favorite charity and wants to find a way to make a substantial contribution.

After conferring with his advisors, Mark decides to contribute $20,000 each year to a charitable remainder unitrust for the next ten years preceding his anticipated retirement at the age of 65. Because the trust has special "flip" provisions, he will get 5% of the annual value of the trust each year but initially only to the extent the trust has income—as distinguished from capital appreciation.

There is also a provision that in the year following the year of his 64th birthday—the "triggering event" for the flip—the trust will begin distributing 5% of its annual value to Mark without regard to the amount of income the trust may have. If the trustee invests the trust assets in a manner designed to produce growth for the first ten years, there will be little or no income to distribute to Mark while he is still working and really doesn't need the income. This also will make the trust principal grow faster. However, the year after he turns 65 he will get distributions for the rest of his life equal to 5% of the annual value of the trust corpus.

Assuming the trust is invested exclusively for growth during the first ten years and achieves a net return of 7% each of those years, the trust principal will grow to $276,329 by the time Mark starts receiving payments. That means his first year distribution will be $13,816—which is 5% of $276,329. If the trust continues to achieve a 7% net return, Mark will receive total payments of $315,575 if he lives his normal life expectancy.

The ten annual gifts he makes while he is still working will generate total deductions of more than $75,000 that could save almost $30,000, depending on his marginal federal income-tax bracket. When Mark dies, the remaining trust principal of just more than $400,000 would be distributed to his favorite charity to fulfill his charitable objectives.

Summing Up

Tax time provides an excellent platform to "grade" the performance of those you advise and to help them identify tax-saving opportunities for 2016 that they might have missed in 2015 and prior years. Taxpayers may be more receptive to guidance to:

- Pay particular attention to the timing of security transactions and the acquisition and disposition of other capital-gain property. Exercise diligence in tracking holding periods to inform your clients when or if to sell.
- Carefully consider if they could secure additional tax benefits by funding charitable contributions with long-term capital-gain property.
- Be intentional about charitable-giving strategies and not leave tax savings on the table that could be captured by bunching deductions into alternating years.
- Not overlook the power of creative charitable planning to enhance their retirement security.

BRIEFLY…

Estate- and Gift-Tax Exemption Equivalent. The estate- and gift-tax exemption equivalent has risen to $5,450,000 for 2016. This is up from $5,430,000 in 2015.

The limit is for an individual, which means that a couple can use the exemption equivalent to offset the tax on up to $10,900,000 of inter vivos or testamentary gifts that otherwise would have been taxable. In addition, a surviving spouse can use any excess exemption not utilized by the first spouse to die.

The gift-tax annual exclusion remains unchanged at $14,000 per donee.

__Financial Strategies__ is intended for a select group of attorneys, accountants, trust officers, insurance advisors, investment counselors, and financial planners. It is designed to keep these planners up to date on developments in estate planning as they relate to testamentary and lifetime plans in support of qualified charities.

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