Tax Planning for Year End 2018

With the end of the year approaching, tax planning is probably high on your list of things to do. We wanted to share some thoughts for you to consider before December 31st. Below are some of the ideas we have:

1. **Contributions to qualified retirement accounts:**

   Reduce taxable income by making maximum pre-tax contributions to qualified retirement accounts such as 401(k), 403(b), TSP, Traditional IRAs. Note that there are income limitations and maximum contribution amounts and often company match considerations.

   Any new plans such as Individual (aka solo) 401(k) plans must be set up and funded prior to year- end to get the income deferral in 2018. IRA contributions for 2018 can be made through the tax filing date in 2019, excluding extensions.

2. **Required Minimum Distributions:**

   We have taken care of this for accounts that we manage. However, for those we don't, make sure to make Required Minimum Distributions (RMD) from qualified tax deferred accounts before year end. Don't forget that for those over 70, if charitable donations are made directly from the custodian to the qualified charity, those donations could toward the RMD and are not taxable income. The penalty for not making a full RMD is 50% of the shortfall. There are some hardship exceptions, but best to get the RMD done before year end.

3. **Roth IRA Conversions:**

   You might want to consider doing a conversion from a Traditional IRA to a Roth IRA or possibly even a conversion within your 401(k) plan to the Roth portion of your 401(k) if available. This should normally only be done if 2018 is a low tax year (e.g. a business owner has losses to offset the income). The conversion creates taxable income at ordinary income tax rates in the year of the conversion but can be offset by other losses such as those from a pass-through business. Note that once the funds are in a Roth account, any future distributions are fully tax free, even the earnings within the investment (assuming the Roth account has been in place for at least 5 years). Having some tax-free sources of cash in retirement can be beneficial to possibly reduce the income tax owed on social security and other retirement plan withdrawals by keeping you in a lower tax rate income bracket. The only change to IRA conversion rules that under the new proposed laws is that Congress eliminated the flexibility to move converted funds from the Roth IRA back to the Traditional IRA if the investments lose value after the conversion.

4. **Contributions to Health Savings Accounts:**

   Reduce taxable income by contributing the maximum amount to Health Savings Accounts (HSA) Plans. These contributions not only reduce taxable income in the year of contribution, but when the funds are used in the future to pay medical expenses, there

is no tax liability. HSA funds do not have to be spent in any particular year and may be invested in stocks or bonds. Since they are very tax advantaged, you might consider paying medical expenses with other funds and waiting to reimburse yourself from your HSA many years down the road. This way the funds in your HSA account grow tax free. Don't forget to keep your receipts to support the eventual withdrawals from the HSA. Note that you must have a qualified high deductible health insurance plan ($1,300 for single, $2,600 or family with out of pocket-maximums ($6,550 for single, $13,100 for family) in order to be eligible to contribute to a HSA. There are no income limits, but there are maximum contributions ($3,450 for single, $6,900 for family; and these limits include any company contributions made on behalf of employees) with $1,000 catch up contribution limits for those aged 55 or more. The non-working spouse will normally have to set up an HSA separate from the working spouse HSA in order to contribute the $1,000 catch-up contribution. Most HSA Plans for the working spouse allow the working spouse to contribute up to the family limit and the catch-up amount for the working spouse, but don't allow contributions for the catch up for the non-working spouse. The contributions can be made before the tax filing deadline, without extensions.

5. **Harvest Capital Losses:**

We did this in the last week of November for accounts we manage. If you have accounts that we do not manage, we would recommend doing this. Harvesting capital losses in a taxable account is a good way to offset the taxable capital gains in the account. Remember that if you own mutual funds and didn't sell any shares of the fund, you may still have capital gains if the fund sold shares at a gain because they must pass those gains on to the investors in the fund. Don't forget about the wash sales rules that prohibit the use of the losses to offset the gains if a substantially identical investment is repurchased before 31 days have passed since your sale. You may be able to find a replacement investment with similar investment characteristics though that is not substantially identical.

6. **Donate appreciated stock to charities:**

If you do make charitable contribution in 2018, it is normally advised to contribute appreciated stock from taxable investment accounts rather than cash. This will eliminate the need for either you or the charity to make tax payments on the gain. You get to deduct from your taxable income (assuming you itemize deductions) the current market value of the shares at the time of the donation and the charity is a tax-free organization. You should remember to replenish your stock investments to stay invested unless you intend to diminish your allocation to stock.

7. **Maximize Gift Exclusions including gifts to 529 educational savings plans:**

You may want to maximize use of your $14,000 ($28,000 per couple) per donee annual gift tax exclusion. Note that contributions to college savings plans such as 529 plans are counted as gifts, but you can use up to 5 years' worth of gift tax exclusions in one year for 529 plans. Also, note that since the lifetime exclusion to gift and estate taxes is likely to be raised, it is unlikely that any gift taxes will be owed on gifts above the thresholds above. Gifts above those exclusion amounts will require that a gift tax return be filed even though no taxes will be due on the gifts. The gifts above the exclusions just reduce the lifetime exclusion

for gift and estate taxes and the lifetime exclusion under the new tax laws is likely to be doubled from the current $5.5 million to $11 million for individuals and twice that for couples who can take advantage of the marital deduction rules for estate taxes purposes.

8. **Consider the timing of stock sales or exercise of stock options:**

To minimize income taxes on sales of stocks and bonds, the stock or bond must be held for over one year because long-term capital gains are taxed at either 0%, 15% or 20%, depending upon your marginal tax rate for ordinary income (i.e. the long term capital gains rate will be lower than the ordinary income marginal tax rates for anyone other than those in the 0% ordinary income tax bracket). If you sell a stock or bond that has been held for a year or less, it will be taxed at your marginal ordinary tax rate. Thus, it becomes necessary to estimate your marginal tax rates this year versus future years if you plan to sell a stock of bond held one year of less. Note that although capital losses can be used to offset other capital gains, only $3,000 of capital losses (holding period doesn't matter) can be used in any one year to reduce ordinary income. Excess losses can be carried forward to offset future year's capital gains and offset up to $3,000 a year in ordinary income.

Non-qualified stock option plans are not taxed to the employee when the options are granted to the employee. However, they are taxed to the employee on any gain when they are exercised, even if the stock is not sold. When exercised, the excess of the exercise price over the grant price is ordinary income and the exercise price becomes the tax basis in the stock. If the stock is sold after the exercise of the option, there would be a capital gain or loss for the difference between the sale price and the exercise price of the option. Any gain would be a long-term capital gain if the stock is held for more than one year after the exercise of the option.

Incentive stock option (ISO) plans are taxed differently. The employee does not recognize any taxable income when the ISO is granted or exercised. There could be an alternative minimum tax impact for high income individuals though. Similar to stock option plans, if the shares of stock are sold after exercise of the ISO they would have a capital gain or loss for the excess of the sales price over the exercise price. Also, sales of ISO shares will be taxed at the long-term capital gains rates if the sale occurs after the longer of 1) two years from the date the ISO was granted or 2) one year from the date of exercise.

-Mike Mills, CFP

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