

Overview of Tax Planning

Keeping more of your wealth

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No one likes to pay taxes, but taxes are inevitable. The good news is there are strategies to minimize their effects, but these strategies must be diligently pursued and implemented every year. In this paper I will examine some of the most common strategies to reduce the income tax bite and increase the amount you will be able to keep in your pocket. Specifically, I will address strategies related to the following areas:

- Tax basis & holding period
- Gifting
- Charitable contributions
- Current versus future tax rates
- Asset placement & conversion
- Tax-loss harvesting
- Income, expenses, & sheltering

Tax basis & holding period

Before beginning the exercise of tax planning we must first understand what is meant by “tax basis” and “holding period.”

“Tax basis” is the amount paid for an asset. This amount is used to determine the amount of future deductible depreciation and/or taxable capital gain/loss.

“Holding period” begins on the date an asset is acquired. When an asset is sold, the holding period will determine whether a capital gain or loss is short term or long term for tax purposes. If an asset is disposed of after holding it for one year, a long term capital gain/loss is realized. If held under one year, a short term capital gain/loss is realized. Since short and long term taxes currently carry much different tax rates (under current law the maximum short term capital gains rate is 35% while the maximum long term rate is 15%), identifying the holding period of an asset before it is sold is critical.

Further, when an asset is gifted carryover tax basis and holding period generally applies. For example, if you purchased an asset for \$1,000 in 1985, your tax basis is \$1,000 while your holding period begins in 1985. If you gift this asset to someone else, even if it is worth considerable more than \$1,000 on the date of the gift, the recipient’s tax basis and holding period will still be \$1,000 and 1985, respectively.

Gifting

As mentioned previously, when gifts are made both the tax basis and holding period will carry over to the recipient (for appreciated property). Therefore, if the recipient intends to sell the asset, the true net value of the gift will be what they receive from the sale minus taxes that will be owed. Therefore, we should only make such gifts if the recipient is anticipated to be in a lower tax bracket than ourselves.

Gifting depreciated property almost never makes sense. Simply put, gifts of depreciated property lose the benefit of a capital loss in the short run. This is a complex subject, but all parties involved would most likely be better off if the grantor of the gift were to first sell the asset, take the loss on their tax return, and then gift the proceeds to the intended recipient. This way the full tax benefit of the loss will be maintained where otherwise it may be permanently lost.

Under current law, assets owned by a person on their date of death receive a step-up in basis to the value on the date of death. These assets will also receive an automatic conversion to long term holding period regardless of when the asset was actually purchased. If low-basis assets are held by an elderly or terminally ill person, it may make most sense to hold those assets until they are distributed by the person's estate. Similarly, it may also make most sense for this person to borrow to meet cash needs, and then have the estate pay the debts of the descendant while receiving a step-up in tax basis.

These issues can be quite complex and also vary according to the unique situations of the parties involved, but the stakes are high. I consistently meet with people that have not properly analyzed the issues, thereby making them *much* less wealthy in the process.

Charitable contributions

When making charitable contributions, the grantor can give either cash or other property. Either way, the contribution is deductible by the grantor (subject to AGI limitations). Generally, a contribution of appreciated property is the best gift since the grantor will receive a deduction while avoiding a taxable gain. Under each scenario the charity will still receive the full benefit of the gift since they will be subject to very little or no tax.

Current versus future tax rates

This may be quite counterintuitive, but it's extremely important to understand: All things being equal, the only thing that matters is the tax rate now versus the tax rate in the future.

Example:

Both taxpayers A & B are subject to current and future tax rates of 25%. Both taxpayers also have a return of 10% during year 1, and then sell their assets directly after year 1. Taxpayer A invests in a tax deferred account while Taxpayer B pays the tax at the beginning of the period and is not subject to tax in the future.

Taxpayer A – Invests \$1,333.33 pre-tax, sells the asset after one year for \$1,466.66 (10% return) and then withdraws the entire amount from the tax-deferred account. The tax is \$366.66, **thus the net value after year 1 is \$1,100.00.**

Taxpayer B – Invests \$1,000 after tax (75% of \$1,333.33), and then sells the asset after one year for \$1,100.00 (10% return). There is no tax, **thus the net value after year 1 is \$1,100.00.**

As you can see, the net available at the end of the period is exactly the same. All things being equal, the only thing that matters is the tax rate in the future versus the tax rate today.

An understanding of this fact is critical in understanding the importance of asset placement.

Asset placement & conversion

As you have seen, all things being equal the critical factor becomes the tax rate now versus in the future. Therefore, one should strive to place assets within accounts most likely to subject them to the lowest overall taxes in the long run.

Ordinary income such as taxable interest has historically been taxed at higher rates than capital gains. Therefore, one should generally place income producing assets such as taxable bonds within tax deferred accounts which will eventually be drawn out as ordinary income anyway.

Tax efficient vehicles should generally be held in taxable accounts. These would include indexed equity vehicles with relatively low turnover and taxable income distribution such as S&P500 index funds. Additionally, since such vehicles are anticipated to have higher long term growth and volatility than bonds, appreciation can be captured at lower capital gains rates and losses can be harvested to offset income. (Harvesting of tax losses will be discussed next). For those in the highest tax brackets, municipal bonds should also be considered for taxable accounts.

Tax inefficient vehicles with high anticipated growth should be considered for Roth type accounts since those accounts will never be taxed. These would include such funds as those targeting REITs or possibly emerging markets. This strategy should be used by only those committed to holding these accounts for the long term, however. Analysis beyond tax planning will be required if the account balances will be required in the shorter term.

Though this subject is a bit complex and will be unique to each situation, you should be aware that vehicle placement will be a very important discussion to have with your financial advisor.

Tax-loss harvesting

No one likes losses, but given the historical volatility of the market, losses are highly likely in the future. Volatility is simply the trade off we take on for anticipated higher long term growth. Once we realize this, we can then look for ways to prudently profit from it. Enter tax-loss harvesting.

Tax-loss harvesting consists of selling a depreciated asset in order to take the loss on our tax return. These losses can be used to offset current capital gains or ordinary income (up to \$3k per year). Losses not allowed are then carried over to future years.

You are a prudent investor and have developed asset allocation targets, however. You know the best plan is to maintain your portfolio at or near its targeted allocation at all times, but you cannot sell an asset to realize a loss, then immediately repurchase the same asset since the loss will be disallowed under the IRS's "wash sale" rules. The answer is to immediately purchase a similar asset to maintain your targeted allocation, wait 31 days, and then move back to the primary investment vehicle.

Example:

Asset A was purchased for \$100k, but is now worth \$80k. The investor sells asset A to harvest the loss, immediately purchases similar asset B to maintain the asset allocation of their portfolio, and then after 31 days the investor sells asset B and uses the proceeds to repurchase asset A. Let's then assume asset A returns to a value of \$100k.

This investor has now captured \$20k in losses to be used against current or future taxable income or gains. Under current tax law this could result in tax savings of as much as \$7k. An investor with the same situation that did not harvest their tax losses simply rode through the dip without capturing any tax benefit therefore will be worse off in the short run. The trade-off is our tax-loss harvesting investor now has a lower tax cost basis, but capturing the tax saving today is money in the pocket. Strategies can then be adopted in the future to deal with the lower tax cost basis such as gifting, bequest, charitable contributions, and/or harvesting of additional future tax losses.

Income, expenses, & sheltering

The issues of income, expenses, and sheltering are perhaps the most complex and unique to each circumstance, but at the core are moving these items to years which will provide the greatest anticipated tax benefit. As we know this will entail predicting current and future marginal tax rates, therefore we want to accelerate expenses to years which have the highest anticipated tax rates and defer income and tax shelter conversion to years which have the lowest. Additionally, a thorough review of tax returns filed in the past three years (3 years is the statutory limit) and current tax returns before they are filed will help insure all items have been considered.

Optimally, you will seek the assistance of a comprehensive financial planner well before the end of the year that has extensive tax planning experience. All too often individuals only seek the assistance of tax preparers after the fact. In these cases not only will it be too late for appropriate tax planning, but tax preparers most often consider only what their clients bring them. Seeking the assistance of a comprehensive financial planner before the end of the tax year that also has a view of your entire financial picture will help insure you are optimizing your after-tax returns. In my experience, these savings can be huge.

Summary

Taxes are inevitable; therefore we must implement strategies to deal with them as such. These strategies must be diligently pursued and implemented every year. Tax preparers most often only consider what their clients bring to them; and most often only after the fact. A comprehensive financial planner with proper experience can assist you to greatly improve your after-tax returns.