Tax and Financial Items for Consideration

Jim Hammond 8/2/16

Tax Changes in 2016

1. Tax brackets are a little wider
2. Standard Deductions up a little, Married, both over 65 $15,100
3. Personal exemptions $4,050
4. Start losing itemized deductions by 3% at $311,000, married filing jointly
5. Much larger Obamacare penalty

If you are turning 63 this year – Watch Income for Medicare

Your Medicare Part B premiums for any given year depend on your Modified Adjusted Gross Income from two years ago. The higher your income, the higher your premiums. Medicare begins at age 65, which means the year you turn 63 is the year you have to worry about affecting your Part B premiums. In 2016, you would pay $1,462 a year for Medicare Part B coverage if you were married and had a Modified Adjusted Gross Income in 2014 of no more than $170,000. If in 2014 you had gone just one dollar over $170,000, your annual Medicare Part B costs would have increased to $2,046 in 2016. If your Modified Adjusted Gross Income had gone over $214,000 in 2014, your Part B costs this year would have increased to $2,923.

Beware of Interest – No Tax Break

Interest is taxed as ordinary income, this can be interest on savings, checking, money market funds, CD's and <u>all Bonds</u> (FL has no income tax so tax friendly bonds do mean anything). Even US Treasury Bills, Notes and Bonds are all taxed at the Federal level, as ordinary income.

Beware of "when" you purchase a Mutual Fund

Postpone purchasing mutual funds in taxable accounts in December. Mutual funds are required to pass realized gains from sales of stock on to the investors in the form of capital gains distributions. Find out when your funds are scheduled to pay out their distributions, and wait until after that to purchase new shares. Otherwise you could own a fund for 1 day and get a huge tax bill. Most of this information is published well ahead of the distribution date, you may actually want to sell the fund before the distribution date, to avoid a tax hit when you have little gains. Keep in mind that the tax loss "wash sale' rule is not enforced for mutual funds.

Is there a tax benefit to being an Independent Contractor (IC) vs. Employee?

1. No, not really. Instead of a W-2 like an employee, an independent contractor gets a 1099. The contractor then must pay all the same Federal taxes. SS and Medicare taxes are due under the term Self-employment taxes, you pay 100% of FICA, but get a 50% adjustment to income (not exactly the same as cash).
2. IC must pay quarterly estimated taxes, penalty if underpaid.
3. IC may have a SEP-IRA, 25% of income up to $53,000, good deal.
4. IC could have much higher "hourly rates" because you save company money on workman's comp, ½ of SS, unemployment comp and healthcare costs.
5. IC's must buy health insurance – Obamacare compliant
6. Can claim business expenses as adjustment to income.
7. Being an IC is a major benefit if your hourly rate is substantially higher than your "salary rate" plus benefits.

Tax and Financial Items for Consideration

Jim Hammond 8/2/16

Tax Friendly Investments – Taxable Account

1. Individual stocks are very tax friend, you choose if you want a stock that pays a dividend, and you choose when a capital gain/loss might occur by selling.
2. If you're in the 10% or 15% brackets (<$75,300 married FJ) for ordinary income, then your long-term capital gains rate is 0%. For those in the 25%, 28%, 33%, or 35% brackets, the maximum capital gains rate is 15%. A top 20% capital gains rate applies to those in the 39.6% ordinary tax bracket.
3. Dividends are generally treated as ordinary income. However, if they are "qualified dividends", they are taxed at the same rates as long-term capital gains. Even for a qualified dividend you have to own the investment during a certain holding period. Specifically, in the 121-day period that starts 60 days before the dividend and ends 60 days after, you have to own the stock for at least 61 days. This prevents short-term "buying a dividend" as a tax-favored dividend payment.
4. Beware of Mutual Funds with high "turn over ratio's" Buying, selling and commissions costs money, plus tax consequences of turnover. Index funds average 5%/yr, try to stay under 50%, some are really high. Actively managed funds Mutual fund managers are charging their shareholders an average of 1.5% a year on that 8% that they are keeping in cash.
5. Suggestion, hold low or no dividend growth stocks unless you need to live off the dividend.
6. If you want mutual funds or ETF's look for "Tax Friendly", beware of Capital Gains Distribution! In general ETF's are more tax friendly than an equivalent mutual fund due to the fact that ETF's really don't have the concept of a long-term capital gain that gets passed on to you by the ETF itself as a distribution.
7. Beware of MLP's K-1's, complicated tax and delayed filing

Tax Deferred Account (IRA, 401K)

1. This is the place to put any stock or fund/ETF that generates high dividends.
2. Good place to trade, but no margin. All gains are tax sheltered.

Tax on Trading Accounts

1. All profit/loss in trading of stocks and options is ordinary income (held less than a year).
2. Futures contract trading has great tax benefits vs. regular stocks. While stocks are taxed at the 35% short-term capital gains rate for positions held less than a year, futures are taxed 60/40. This means that while 40% of your gains in futures trading is taxed at the same 35% rate as short-term stock trading, 60% of your gains are taxed at the long-term capital gains rate of 15%! That is a total of 23% (60% x 15% + 40% x 35%) difference in tax rate.
3. If you set up a corporation to trade under, like an LLC the profit/loss less business expenses are shown on a K-1 and reported to the LLC "Members" as Business Income.

Retired and A Spouse is under 65 – Take advantage of huge Obamacare Credit $7,000

If you have a unique situation where both spouses are retired, and one is too young for Medicare, don't take Social Security. Instead live off cash if you can, pay no taxes AND get up to $7.000 back as an Obamacare tax credit.

Tax Loss Harvesting – Very Best Kept Secret

1. This is the #1 best kept secret in the tax planning world.
2. You can deduct stock sale losses of $3,000/yr maximum, this can be carried forward. Always have a $-3,000 Capital Gains by tax loss harvesting.
3. In your taxable stock account, sell losers you aren't happy with.

4. Sell stocks with gains to reset lower “costs basis”. For example, before year end you have a few stocks that have loss money, sell them. Let’s say your net loss is $23,000. Then sell enough of your highest gainer stocks so that you sold a new gain of $20,000. In total you have a $-3,000 Capital Gains loss for the current year. Immediately buy back the stocks that had a gain for $50,000. What have you accomplished, besides the -$3,000 tax loss? You have reset your “cost basis” for your best performing stocks to the current market price. This becomes valuable in the future.
5. Be careful of “wash sale” rules if you sell a stock at a loss, you can’t repurchase it or a substantially identical stock for 60 days.
6. Remember all losses can offset all gains in the same year.

How Much of Social Security is Taxable?

1. A maximum of 85% of social security is taxable.
2. However the calculations of this is based on your AGI, ONLY including 50% of the total SS amount.
3. For example, the maximum SS payment this year (spouse age 70, other taking spousal benefits at FRA) is $58,746. With standard deductions and 2 Exemptions, you could have up to $18,000 in “ordinary income” and pay $0 taxes in 2016. Or you could have up to $34,500 in “qualified dividends” and pay $0 taxes.
4. See the example 1040 Tax returns provided by Jim Hammond showing how, with careful planning, a substantial chunk of Qualified Dividends can be taken and still pay $0 taxes.

Beware of Mutual Fund Fees – This is a Killer

Example, you invest $50,000 for 10 years and get a 5% annual return. This is the value after 10 years

a. Vanguard 500 Index Fund $81,038
b. Fidelity Contrafund $75,863
c. Allianz Health Science $59,988
d. Here is a great site to compare “apples to apples” in funds: http://apps.finra.org/fundanalyzer/1/fa.aspx

Again, keep in mind that the above comparison is at the same performance for all 3 funds, 5%. Mutual fund fees can make a huge difference. Compare mutual funds to ETF’s and actual stocks (no fees).

HSA Accounts – The Very Best Tax Dodge

See jhammondblog.com

Plan for RMD at age 70 ½

See jhammondblog.com

Pay-off Debt before Investing

Consider your realistic rate of return when taking on, or paying off debt. If debt is costing you 12%, pay it off before investing for 6%. This might include suspending unmatched 401k contributions.

Beware of This – How do Bonds Work – The Problem

Say that you buy a $1,000, 10-year Treasury bond, with a 2% coupon rate. (pays $20 interest per year.) You hold that bond for five years, it is now effectively a 5-year Treasury bond with a 2% coupon rate. Now imagine that, over those five years, interest rates have risen, and newly-issued 5-year Treasury bonds are now paying 4% interest. If you now wanted to sell your bond for $1,000, you’d have a very difficult (impossible) time. Nobody would want to buy your bond with its 2% interest rate, when they could just buy new bonds with a 4% interest rate instead. In order to sell your bond, you'd have to sell it for substantially less than $1,000. The longer the bond, the more risk there is.

Right now money is just pouring into bonds and bond funds from all over the world. This forces the yield down. When interest rates rise no one will want the older bonds with lower rates, they will lose their principle value if you try to sell them. You might say, just hold onto an individual bond until it matures, say 10 years. However, you might make more money in interest with a newer higher yield bond.