INVESTMENT TAX GUIDE
2017 EDITION

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CEO of Personal Capital
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It’s not what you make that counts, it’s what you keep. Invest well, and then arrange your investments to minimize the resulting taxes. This book has everything you need to know, and nothing you don’t.

I’ve been working on taxes for 26 years – ever since I ran the company that makes TurboTax, the software used to file more than half the tax returns in the country. But tax preparation – calculating your taxes – is the easy part. Tax planning – minimizing your taxes – is the challenging part.

The good news is that a few powerful concepts are all you need to know. With that, and a knowledgeable financial advisor to help execute your strategy, you can maximize the value that goes to your retirement.

In fact, Congress created special tax breaks to encourage you to fund your retirement. Go get yours.

- Bill Harris, CEO of Personal Capital
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INTRODUCTION
It’s not what you make, it’s what you keep.

You can’t escape income taxes.

They’ve been a permanent fixture in our lives at least since the U.S. Congress enacted an income tax in 1913.

For investors, particularly, taxes are something to pay attention to. They can seriously impact your long-term returns and, consequently, your net worth.

But, figuring out your taxes can get complicated fast, and mind-numbing, even if you’re an accountant or tax law specialist.
This book keeps it simple. We’ll tell you what’s essential to know to help you make informed tax-smart decisions. We don’t skirt the complicated concepts. We explain them in understandable terms.

The tax strategies and planning techniques you choose to implement will depend on your financial goals, of course, and a professional advisor is best equipped to help you build a plan and reach those goals.

Most likely you’ll find that there’s not one magic strategy that will dramatically deflate your tax bill. Instead, it could take a lot of smaller tweaks that collectively can maximize your investment returns – meaning extra money to sock away into a college account for the kids, or to grow your retirement savings.

Let’s start with Rule #1 for tax-smart investing: It’s not what you make that counts but what you keep – your after-tax returns.

Whether you’re a life-long investor or just starting out, there are several key strategies to consider when investing with an eye on taxes:

- Focus on tax-efficient investments
- Place your investments in accounts that give you tax advantages
- Make your potential losses work for you, not against you, and
- Consider converting a traditional IRA to a Roth IRA

We’ll discuss the tax benefits and pitfalls of each of these, and potential strategies to help you make these tax-wise decisions. Not all the strategies apply to every individual investor, of
course. Factors, such as your tax bracket, how long you want to hold the investment, or the risk level you’re comfortable with, need to be weighed against the tax implications.

But the take-away here is that being tax-aware is always a smart approach.

Ben Franklin had a lot to say about taxes. Consider this nugget of advice: “Taxes are indeed very heavy (but) we are taxed twice as much by our idleness, three times as much by our pride, and four times as much by our folly.”

No one – particularly investors – can afford to be tax foolish.
TAX EFFICIENCY
How much of each dollar do you keep?

In this chapter, we look at some tax factors to consider before you buy stocks, mutual funds, bonds, Exchange Traded Funds (ETFs) or Real Estate Investment Trusts (REITS).

Some of these assets are more tax-efficient than others. Some are notoriously tax-inefficient.

Once you’re aware of how these investment choices can affect your tax burden, you can also make better decisions on where and how to invest: is it better to buy stocks, for example, in one of your taxable accounts – on which you pay taxes as you receive
income or realize gains – or a tax-deferred or tax-exempt account, such as a retirement account? What about mutual funds? Does it matter where you place them at all?

In fact, tax location, as this strategy is commonly called, can be of enormous significance. Chapter 4 discusses, in greater detail, the benefits of placing different assets in appropriate places to minimize your tax load.

Here, we describe the basics of the different investment choices you have – and their tax treatment.

There are a head-spinning number of investment products out there to choose from – 9,000 mutual funds, alone, and a robust industry to help you pick what’s best for you. But, of course, mutual funds are only one of many investment products. We’ll start with individual stocks and move on from there.

**Individual stocks**

There are more than 4,300 publicly listed companies in the country today – a historically low number, actually, but still a lot of stocks for an individual to choose from.

Online tools abound that can help you evaluate and analyze individual stocks to build a diversified portfolio, but unless you plan on turning stock research into your full-time job, picking stocks is often best left to the pros.

But, individual stocks have one enormous benefit – from a tax perspective individual stocks rank high in tax efficiency.

Here’s why individual stocks are tax-efficient:
• Stocks come with a built-in tax break. You can watch your stocks’ values grow on paper (one hopes) and you can put off taxes on capital gains until you sell.

• Qualified dividends and capital gains from individual stocks are taxed at a lower rate than ordinary income, and depending on your tax bracket, you could avoid taxes completely at the end of the year.

• Owning individual stocks puts you in charge of buying, holding and selling your shares. Your broker takes orders from you – for a fee, of course--although the costs of those brokerage commissions have been dropping dramatically. And, unlike mutual funds, for example, you can generally buy or sell shares anytime during the trading day.

• From an investment planning perspective, owning individual stocks gives you the choice to place them in tax-beneficial ways. (See Chapter 4.) Depending on your personal goals and needs, you can place them in regular taxable accounts, or in tax-deferred or tax-free accounts. (See Chapter 3 for tax-advantaged accounts.)

• The timing of the sale of your individual stock and other securities allows you to use tax-minimization strategies, such as tax-loss harvesting (explained in Chapter 4), which permits you to use your stock losses to offset your gains.

**Tax Tip – Defer Gains**
One time-proven strategy if you invest in individual stock is to hold on to stocks for the long term. If you hold on to a stock—or any investment for that matter- any gain you incur will be taxed as a long-term gain. The tax rate on long-term capital gains is
significantly lower than on short-term capital gains, gains on assets you sell after you have held them for one year or less. In addition, you’ll be deferring your taxes on the gains, until the time you decide to sell. You may be taxed at the lower capital gains rate if you’ve earned less in the year in which you sell.

**Tax Tip – Stepped-Up Basis**
If you pass your stocks on to your heirs as part of your estate, they can pay less tax than you would have. Your capital gain is figured by calculating the difference between your *cost basis*, the price you purchased the stock for, and the sales price. However, if a stock is passed on to an heir, the cost basis is the price of the stock at the time of death—which could be considerably higher than the price you paid for the stock.

**Mutual Funds**

The concept of mutual funds is simple enough – investors pool their assets and professionals manage them. You buy into a mutual fund, typically a basket of securities, and you share in all its activities – fees, gains and taxes.

Great idea – particularly for those who can’t afford a financial advisor or don’t have time to manage their own stock portfolio. But when tax time rolls around, many mutual funds lose some of their appeal.

A 2010 study by Lipper, a mutual-fund research company, found that owners of mutual funds in taxable accounts gave up an average of .98% to 2.08% in annual return to taxes over the previous 10 years. That may sound miniscule but look at the difference even 1% makes over 10 years, as shown in the chart.
below. On a $100,000 portfolio, that comes to $17,630 less, and over 20 years to $66,255 less!

Here’s why conventional mutual funds are famously tax inefficient:

- Mutual fund managers are generally not factoring in tax implications of their buying and selling decisions. Their focus is on beating the overall market return and that investment return is calculated before factoring in taxes. Mutual funds managers—who are competing with other mutual fund managers to catch investors’ cash—generally make their buy and sell decisions based on maximizing returns before taxes returns. Once taxes are figured in, the after-tax picture can be far less attractive.

- If you own mutual funds, you could be liable for taxes on gains in which you didn’t participate. (To minimize this problem, buy shares after the fund distribution date, so you’re not also buying the tax bill for that year. Funds generally provide anticipated distribution dates in late
autumn, if the fund makes annual distributions. Check your mutual fund company’s website for fund distribution information.)

- Mutual funds are also tax inefficient because of their high turnover rate. The average mutual fund turnover rate – the percentage of a fund’s holdings that changes over the year – is between 75% and 85%. Why does turnover matter? For one thing, all those sales can generate taxable gains that are distributed to you, the shareholder, at the end of the year.

- Hyper turnover rates also mean higher transaction costs. All told, the drag on an average actively managed mutual fund due to high transaction fees, sales charges and other expenses is significant. Compared to a passively managed index fund, for example, the lower cost index funds have a 2.25% annual cost advantage, according to Vanguard founder John C. Bogle in a New York Times interview.

- Mutual funds come with some unknowns. Buy and sell orders of mutual funds are traded at the end of the day. The price per share is known as the net asset value (NAV). When you buy one share of a mutual fund the price is the NAV at the end of day. Since you are buying at yesterday’s price, you don’t know the exact NAV when you buy shares. You could end up with more or fewer shares than you intended.

- Fund managers frequently engage in an end-of-the-quarter or end-of-the-year strategy called window dressing. It works like this: At the end of the quarter or year, a fund manager will sell stocks showing a loss and then load up on high-flying stocks that have shown gains during the quarter or year. When you look at the funds end-of-the
quarter portfolio, what you see listed among the fund’s holdings are the high-flyers. The losers may be nowhere to be seen—though they may, of course, have had a significant effect on the fund’s recent performance.

**Tax Tip – Mutual Funds**

If you decide there’s room in your portfolio for mutual funds, it’s smart to avoid those that are actively managed—those with high turnover rates—and therefore, less tax-efficient. If you feel, for example, that you need some exposure to the health care sector, you may want to go with an index fund that tracks the performance of health care companies. Index funds generally come with lower turnover, fewer taxable gains and lower fees.

**Index funds**

Index funds – mutual funds or ETFs that track the performance of a specific market benchmark, such as the S&P 500 index—are, as we mentioned, generally more tax efficient than actively managed mutual funds.

Here’s what makes index funds tax efficient:

1. Broad index funds trade less frequently than actively managed funds, generating less taxable income, which reduces your tax exposure.

2. Fees on index funds are lower than on conventional mutual funds, because index funds are less expensive to manage.
But, index funds can deliver some unpleasant surprises:

Index funds, like other mutual funds that focus on specific sectors, can also generate dividends and capital gains at the end of the year. When markets decline and some investors redeem their shares, your end of year capital gains may be higher than you expected, even if the value of your shares in the index fund has dropped.

At the same time, because of the limited involvement by fund managers in picking and managing specific stocks, index funds may not be able to switch course quickly to react to stock market changes.

**Tax Tip – Fund Fees**

What you pay in management fees on mutual funds matter. Rather than paying high fees on the many mutual funds that try to beat the market, you can incur lower management fees on index funds. The actively managed fund and the index fund may have similar investment performances, but you’d do better with an index fund that charges a smaller management fee.

**Exchange Traded Funds (ETFs)**

One way to look at an exchange traded fund or ETF is as a wrapper around a basket of stocks, bonds, or other investments. Like mutual funds, ETFs offer a variety of portfolio choices, depending on your goals – a diversified portfolio, for example. Index ETFs that mimic major indexes, such as the Dow Jones Industrial Average, or the S&P 500, can put you into a wide range of market sectors. Others are geared to specialized areas – energy, bio-tech, utilities, you name it.
ETFs have been around since the early 1990s, and in recent years have ballooned in numbers – 1,700 ETFs are now being traded with a combined value of more than $2.5 trillion, according to an Investment Company Institute report for 2016. ETFs are popular with seasoned investors, and increasingly with the millennial generation (now ages 18 to 34).

ETFs can be a better choice than conventional mutual funds for multiple reasons:

1. ETFs are generally more tax efficient than mutual funds, though you’ll want to compare the relative costs of ETFs and mutual funds that track the same indices. But the way ETFs are structured means fewer capital gains are generated within ETF shares. When you buy ETF shares you are buying a portion of the fund on an exchange at an agreed upon price. When you sell, your shares are sold to another investor, just like stock. So, it’s unlikely that you’ll face a significant capital gains distribution from the ETF at the end of the year, as you might with mutual funds, because the underlying stocks in the ETF proposal are never bought or sold – unless the index, itself, is tweaked, which rarely happens.

2. ETFs are more flexible and transparent than mutual funds. Like stocks they trade throughout the day and, unlike with mutual funds, you know the value of your shares when you put in the order. Most ETFs, but not all, disclose their full portfolios online every day. Just go to www.ishares.com and plug in the ETF name to find the fund’s complete holdings.
3. Like index funds, most ETFs are passively managed and may therefore have the lower turnover rates, fewer expenses and lower trading costs.

4. Unlike mutual funds, which often require a minimum investment of $1,000 to get into, with ETFs you can often buy in with less than $100 – a few weeks’ worth of caramel macchiatos – not a huge sacrifice to start building a diversified portfolio. If you’re investing small sums, take a hard look at brokerage fees. Even though they are fairly low on ETFs, you want to be sure, at least, that you will be able to recoup your buying cost.

ETFs generally work efficiently, tracking an index and trading close to the net asset value. But, like any investment, there can be some risks.

1. ETFs are subject to the vagaries of the index they follow. When the S&P plunges so does your S&P 500 ETF.

2. An ETF can decide to shut down, as about 100 do each year. The reasons vary – a low level of assets under management, or the issuing company is unprofitable, for example. If an ETF you hold does announce that it’s shutting down, what should you do? The best advice: sell out as soon as an announcement is made. That way you could avoid sharing in the costs and capital gains associated with the liquidation process.

3. From a tax perspective, conventional stock and bond ETFs are generally known quantities. But, some ETFs are more complicated or exotic. ETFs that hold gold bars, for example, could have slightly higher capital gains effects when you sell.
**Corporate bonds**

Bonds are fixed-income investments. Like certificates of deposit, for example, they generate a specific or fixed level of income on a regular basis. Bonds can be attractive to some investors who want a steady stream of income and want to preserve, rather than grow, their principal—although the price of a bond can fluctuate widely, just like a stock. Generally, the price of a bond rises, as the interest rate it offers falls, and vice versa.

Corporations issue bonds to raise money for expanding their business, buying another company or a variety of other reasons. When you buy a corporate bond, you are, in essence, making a loan to the company for a period of time. In return, you get periodic interest payments, usually twice a year, and their promise to repay the face value of the bond when it matures and become due.

The corporate bond market is huge—some $5 trillion in corporate bonds denominated in U.S. dollars. Corporate bonds are generally longer-term debt instruments with a maturity of at least one year. They can be high-grade investment bonds or more speculative high-yield bonds, also called junk bonds, depending on their credit rating. Generally, the higher the credit rating on a bond, the lower the interest rate offered.

There are some downsides to corporate bonds:

1. Bonds and some bonds funds can have high taxable yields and high capital gains. The income you get from bonds is taxed at your ordinary income tax rate, which is higher than the capital gains rate available for stocks held for a year or longer.
2. Bonds come with some risks. While U.S. government bonds are unlikely to default on their payments—at least that’s been the norm—the threat of default is greater with corporate bonds, as well as the bonds of municipalities, foreign governments and other entities (for example, a quasi-government organization formed to finance the building of a nuclear power plant). The risk of default depends on the underlying entity’s performance, its bond rating, market conditions and various other factors. Any unexpected changes in tax policy can also hurt the bond’s value.

3. As with mutual funds, investors in bond funds give up some control that can have significant tax effects on your return. The fund managers—not you—make the decisions to buy or sell, and when to do so, limiting your ability to take advantage of possible tax-saving strategies.

**Tax Tip – Bond ETFs**

One strategy to gain exposure to bonds may be to place a passive bond mutual fund that follows a “buy and hold” strategy into your portfolio. Bond ETFs also do the trick since they trade on an exchange and don’t generate excessive trading fees. Fewer capital gains are generated as well, especially if the ETF tracks an index.

**Municipal bonds**

So-called muni bonds are issued by states, cities and other localities to help finance the construction of roads, schools or other public projects. As with a corporate bond, when you buy a
municipal bond you are in effect lending your money – not to a company but to a state, city or other government entity.

In exchange, you get regular interest payments, usually semi-annually, and a promise that when the bond matures, you will get back your original investment or principal. The maturity date for munis – when the issuer repays your principal – can be long-term, say ten years, or short-term, one to three years.

When it comes to tax-efficiency, muni bonds get the top award. Interest on munis is generally not taxed at the federal level – and maybe not even at the state (or city) level, depending on where you live.

Say, you live in a high tax state like New York or California. You can generally buy a muni issued by your home state and not pay any state taxes on it. This tax-free income can be especially significant if you are in the higher tax brackets.

But even if you can’t avoid paying state taxes, not paying federal taxes on munis is in itself a major attraction. Say the yield on your muni is 5% and you are in the 35% tax bracket. You would need an estimated yield of about 8.28% just to break even on an after-tax basis.

Munis are also attractive because they generally have higher credit ratings and are less volatile from a price perspective compared to corporate bonds.

It’s not all good news, however. Watch out for these pitfalls.

1. Income from a municipal bond can trigger the alternative minimum tax. The alternative minimum tax, in essence, subjects you to a higher tax rate than your ordinary income
tax—if you receive certain kinds of income. And tax-free income from some muni bonds is one of the kinds of income that triggers the AMT. The result, of course, is that you pay more in taxes. For example, if you are in the 28% marginal AMT tax rate – a 4% yield on a muni bond, could end up looking more like 2.88%. (See more on the AMT in Chapter 2.)

2. You can be subject to a further tax hit on your interest income from a muni bond if you are on Social Security. Here’s how: Even though muni interest is tax free, the IRS requires you to include it when you figure your modified adjusted gross income, the calculation that determines taxes on your Social Security benefits.

3. Munis can be subject to the effects of catastrophic events. Municipalities facing a financial crisis can default on their bonds, that is fail to pay the interest or principal. That was the case in 2016 when Puerto Rico defaulted on about $1 billion of muni bonds, leaving its bondholders in the lurch.

4. A diversified portfolio of individual munis requires a large investment, typically $100,000 to $200,000. Watch out for broker commissions and markups. Some of those fees may appear on your purchase confirmation statement, some not, so be sure to ask about them upfront.

**Tax Tip – Munis**

For wealthy investors who can afford the large initial investment to buy a diversified portfolio of munis, their tax-free nature is appealing, compared to taxable bonds. Yields on munis tend to be lower because of the tax advantages, making them most useful if you are in the highest tax brackets.
**Tax Tip – Muni ETFs**
But, there’s another way you can benefit from munis without making such a large upfront investment – bond ETFs and muni bond funds may be the way to go. There are even some state-specific muni bonds for high-tax states like California and New York.

**Treasury bonds**

Treasury bonds are U.S. Treasury securities backed by the government and can be purchased through a brokerage or at TreasuryDirect online (except for bonds intended for an IRA account).

Compared to many other investments, they have a special appeal. First, if you are risk-averse, a U.S. Treasury bond will let you sleep at night. The chances of default are somewhat less than most other investments. So you are virtually guaranteed the return of your principal. And, they can also provide a stream of predictable income.

This level of safety comes at a cost. The interest rate paid on Treasuries is generally lower than the interest rate offered on other bonds. Even though interest income from Treasuries is taxed at the federal level, it is exempt from state and local taxes, which can provide a nice boost to your total after-tax return.

**Tax Tip – Weigh All Factors**
As with any other investment—but especially with bonds—the tax implications of your holdings need to be weighed against other factors – your risk tolerance and your need to protect
your investment dollars. Being aware of the tax implications on your fixed income investments can only lead to wiser decisions.

Real Estate Investment Trusts (REITs)

Real estate investment trusts (REITs) are companies or investment funds that invest in income-producing real-estate. Generally, REITs focus on specific segments of the market, such as retail, healthcare, or office properties.

To qualify as a REIT, a company must payout at least 90% of its income, such as rental income, in the form of dividends. For individual taxpayers, those dividends can be costly in terms of taxes. That’s because dividends from REITs are taxed at the higher ordinary income rate.

Tax-wise, REITS may not offer any special treatment, but they have other advantages that can make them attractive. Historically, returns on REITs have had a low correlation with stock and bond indexes. So, when stock and bond indexes go down, REITS generally perform well. In addition, the returns on REITs generally average just above inflation.

So, as a way to minimize your overall market risk and balance your portfolio, REITS may make sense – just don’t expect any tax benefits.

Tax Tip – Real Estate Exposure with Liquidity
Buying a house or any other piece of residential or commercial real estate, usually requires a significant outlay of cash. If you want to invest in real estate without making a down payment, REITs may be your best option. They offer exposure to the real
estate market, without locking in your capital for a long period. That in turn, can allow you to use your capital in more tax efficient ways.

REIT ETFs

REIT ETFs, or real estate investment funds that are exchange traded, might be a better choice for many investors. Here’s why:

1. Most REIT ETFs are made up of residential, commercial, and industrial properties, offering geographic and sector diversification

2. REIT ETFs offer a return that is more in-line with the overall real estate market and can be an efficient way to gain exposure to this asset class.

3. Dividends from REIT ETFs are taxed at ordinary income tax rates, like REITs, but you may nevertheless want to consider REIT ETFs to help diversify the risks of stocks and bonds in your portfolio.

Tax Tip – Homeowners Should Own REITs
If you already own a home, should you exclude REITs from the portfolio? Probably not – unless you own several properties in multiple geographic regions. REITS can give you that kind of diversification. REITS can also be good candidates for your IRA accounts because you can defer the taxes on their high dividends.
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<th>Approximate Tax Efficiency Ranking</th>
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<tr>
<td><strong>Most tax efficient</strong></td>
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<tr>
<td>1. Muni bonds</td>
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<td>2. Individual stocks</td>
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<td>3. ETFs</td>
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CAPITAL GAINS
Capital gain tax rates are at historic lows.

When it comes to taxes, your investment gains are not all treated equally. First of all, capital gains income is considered unearned income—you make it on an investment, unlike the ordinary, sweat of the brow income you earn by working—which is not to say that investing can’t be work!

But, things get more complicated. Capital gains are taxed differently depending on how long you hold the asset—there are short-term gains, for assets held for one year or less and long-term gains, for assets held longer than a year. Capital losses
are also taxed differently depending on how long the asset is held.

Smart investors know they have to consider the tax implications of their decisions before – not after – putting down their money, so it pays to know some basic rules of taxes on your gains.

This chapter starts with a look at a core aspect of the tax code – your tax bracket – and how your money is taxed within your bracket, your marginal rate. We then discuss capital gains – income you generate by buying an asset at a low price and selling it at a higher price.

Capital gains taxes can cost some investors nothing, but they can also put a major dent in the portfolios of others. We suggest some strategies to minimize the effects of capital gains and decrease your tax bill. And we also untangle two other taxes that can creep up on you – the alternative minimum tax and the 3.8% net investment income tax, both focused on the wealthy.

First let’s look at your tax bracket and marginal tax rate, and see how much you really pay in taxes.

**Know Your Tax Bracket**

Our federal income tax is a progressive tax system: the more you make, the greater percentage Uncle Sam wants. So the greater your taxable income – what’s left after you claim the deductions and the exemptions you are entitled to – the higher your maximum tax rate or tax bracket will be.

But that doesn’t mean all your taxable income is taxed at the highest rate. Here’s how it works.
Currently, there are seven federal income tax brackets from 10% up to 39.6%. Which bracket you’re in depends on if you’re single, married and filing with your spouse, married and filing separately, or if you are a head of household (unmarried and maintaining a home for a relative whom you claim as an exemption).

How much tax you pay on your income depends on your bracket and filing status, as the chart below shows. Your marginal tax rate is what you pay incrementally as your income rises.

Not all your income is taxed at the same rate. Your tax rate changes as you earn more money but the rate on the earlier money stays the same. So, say you’re in the 28% bracket, you pay taxes at four different rates: 10%, 15%, 25% and 28% on different levels of your income.

To find your bracket, first figure your taxable income: Take your adjusted gross income and subtract any deductions or exemptions you’re claiming for the year.

**Example**
You are single and your taxable income is $100,000. You’re in the 28% bracket ($91,151 to $190,150). Here’s how your taxes break down. You pay at a:

- 10% tax rate on the first $9,275
- 15% for the amount between $9,276 and $37,650,
- 25% for the amount between $37,651 and $91,150, and
- 28% for the rest
Your tax bill is: $21,037. You may be in the 28% bracket but your effective tax rate, or taxes as a percent of your income, comes out to 21.04%.

<table>
<thead>
<tr>
<th>Rate</th>
<th>Single</th>
<th>Head of Household</th>
<th>Married Filing Jointly</th>
<th>Married Filing Separately</th>
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<tbody>
<tr>
<td>10%</td>
<td>Up to $9,275</td>
<td>Up to $13,250</td>
<td>Up to $18,550</td>
<td>Up to $9,275</td>
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<td>15%</td>
<td>$9,276 to $37,650</td>
<td>$13,251 to $50,400</td>
<td>$18,551 to $75,300</td>
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<td>25%</td>
<td>$37,651 to $91,150</td>
<td>$50,401 to $130,150</td>
<td>$75,301 to $151,900</td>
<td>$37,651 to $75,950</td>
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<td>28%</td>
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<td>$130,151 to $210,800</td>
<td>$151,901 to $231,450</td>
<td>$75,951 to $115,725</td>
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<td>33%</td>
<td>$190,151 to $413,350</td>
<td>$210,801 to $413,350</td>
<td>$231,451 to $413,350</td>
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<td>35%</td>
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<td>39.6%</td>
<td>$415,051+</td>
<td>$441,001+</td>
<td>$466,951+</td>
<td>$233,476+</td>
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A good online calculator can help you estimate your marginal tax rate for the year.

Caution: Nothing is simple in the tax code. Even after your figure out your tax rates, that doesn’t mean you won’t face other rules that could push up your taxes even more.
For one thing, Congress is increasingly fond of raising revenues without changing tax rates. How? By tightening up income limitations and phase-out ranges on tax breaks, such as the phase-outs for the student loan interest deduction, the tuition and fees deduction, among others. Squeezing income limits and phase-outs excludes increasing numbers of upper income taxpayers from the tax breaks.

Another consideration is the “stealth” taxes that can creep up on you if your income exceeds certain amounts. One is the Alternative Minimum Tax (AMT), which can add thousands to your tax bill if you are entangled in its net. Another is the Net Investment Income Tax (NIIT), which will cost you another 3.8% on top of your regular tax bill. Both are discussed later in this chapter.

**Tax Tip – Marginal Rates**

Once you know your tax bracket and your marginal rates, you can get a better handle on your investment decisions. A simple example, how will a check to your favorite charity affect your taxable income at the end of the year? If you are in the 15% tax bracket and give a $100 contribution, your actual cost is $85 ($100 – the $15 tax savings). The actual cost of charitable gifts decreases for taxpayers in top brackets. For someone in the 33% bracket, a $100 contribution really costs them only $67 ($100 – the $33 tax savings).

**Tax Tip – Tax-Deferred Accounts**

One way to help reduce your taxable income is to put more money into a retirement account, such as a traditional IRA or a 401k income. Any contributions you make, up to certain limits, will lower your taxable income and your taxes for that year.
Putting after-tax income into a Roth IRA can be even a better choice because your gains are tax-exempt. (See Chapter 3)

**Tax Tip – Rates May Change**
It’s too soon to tell but the current tax brackets could change under the current administration. Some changes being discussed are to reduce the current seven brackets to three, with rates of 12%, 25% and 33%, and to do away with the head of household filing status. It’s something to keep in mind as you chart your tax planning for next year.

**Interest Income**

When you get interest on a savings account or a certificate of deposit, for example, your interest does not get any favorable tax treatment. The price of the asset doesn’t fluctuate as in stocks or funds and you don’t realize capital gains income because there’s no sale involved. You sit back and receive or withdraw the interest you’ve earned on your money. But, you pay for the convenience at tax time – interest is taxed at your ordinary income tax rate, depending on your tax bracket.

Here’s what qualifies as taxable interest payable at your ordinary income rate:

- Deposit accounts, checking and savings
- Certificates of deposit (CDs)
- Distributions, or dividends, on deposits at credit unions and other banks
- Personal loans you make
- Most U.S. bonds (except municipal bonds)
- Insurance dividends
- Income tax refunds
Exception: You pay no interest on municipal bonds at the federal level, or on private activity bonds (tax-exempt bonds issued on behalf of a local or state government for certain projects). But private activity bonds may be taxable under the alternative minimum tax, which we discuss later in this chapter.

**Tax Tip – Savings Bonds**

There’s a tax advantage for some taxpayers who hold certain qualified U.S. savings bonds (Series EE and I issued after 1989, for example). You pay interest on these bonds when you redeem them, but you may be able to exclude some of the interest if you pay certain higher education expenses during the same year. This exclusion is known as the Education Savings Bond Program. For more on the program go to: www.irs.gov/publications/p970/ch10.html

**Capital Gains**

When you sell assets like stocks, bonds, mutual fund shares, ETFs, or your home, your profit is taxed as a capital gain, a generally lower rate than your ordinary income rate.

Capital gains can be long-term or short-term, depending on how long you’ve owned the investment.

- A long-term gain occurs when you generate a profit on an asset that you’ve owned for more than one year. Long-term capital gains are taxed at a lower rate than short-term capital gains. Therefore, you want a long-term gain whenever possible to get the lower federal capital gains rate – from 0% to 20% or more, depending on your tax bracket. (There could be additional state taxes as well.)
• A short-term gain occurs if you hold the asset a year or less. You’ll want to avoid generating a short-term gain as much as possible since it gets taxed at the higher ordinary income rate, up to 43.4%, depending on your tax bracket. (Again, state taxes could apply.) So, unless there are other reasons to sell, hold off for at least one year.

• Capital gains on the sale of your primary residence are treated differently – your first $250,000 ($500,000 for couples) in gains may be exempt from taxes, assuming you’ve lived in your house for two out of the previous five years. (See Chapter 5.)

• Some long-term gains on things like collectibles for example are taxed at a 28% tax rate.

Your tax bracket and your holding period can make a huge difference on your capital gains liability, as the tables below show. Who stands to gain most?

Lower income investors who have a long-term capital gain stand to benefit most. If you’re in the 10% and 15% income tax brackets, you pay no taxes on your capital gains.

Wealthier investors in the 39.6% tax bracket also do well – they pay up to a 23.8% rate on their long-term gains compared to 39.6% on short term gains.

Examples
You and your spouse file jointly and have $65,000 in taxable income plus a long-term gain of $10,200 from stock sales for a
total income of $75,200. You owe no taxes on your entire gain of $10,200. (See capital gains table below.)

You and your spouse file jointly and have $300,000 in taxable income and the same long-term gain of $10,200. Your long-term capital gain is taxed at a 15% rate.

You are in the 25% tax bracket and your profit on a sale of shares is $4,000. You owned the shares for nine months. You are taxed at the ordinary income rate. Your tax is $1,000 (25% of $4,000)

You are in the 25% tax bracket and your profit on a sale of shares is $4,000. You owned the shares for at least one year. You are taxed at a long-term gain rate of 15%. Your tax is $600 (15% of $4,000).

Capital gain tax rates for single taxpayers:

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax bracket</th>
<th>Short-term capital gains rate</th>
<th>Long-term capital gains rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $9,275</td>
<td>10%</td>
<td>10%</td>
<td>0%</td>
</tr>
<tr>
<td>$9,275 to $37,650</td>
<td>15%</td>
<td>15%</td>
<td>0%</td>
</tr>
<tr>
<td>$37,650 to $91,150</td>
<td>25%</td>
<td>25%</td>
<td>15%</td>
</tr>
</tbody>
</table>
Capital gain tax rates for married filing jointly:

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax bracket</th>
<th>Short-term capital gains rate</th>
<th>Long-term capital gains rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $18,550</td>
<td>10%</td>
<td>10%</td>
<td>0%</td>
</tr>
<tr>
<td>$18,550 to $75,300</td>
<td>15%</td>
<td>15%</td>
<td>0%</td>
</tr>
<tr>
<td>$75,300 to $151,900</td>
<td>25%</td>
<td>25%</td>
<td>15%</td>
</tr>
<tr>
<td>$151,900 to $231,450</td>
<td>28%</td>
<td>28%</td>
<td>15%</td>
</tr>
<tr>
<td>$231,450 to $413,350</td>
<td>33%</td>
<td>33%</td>
<td>15%</td>
</tr>
</tbody>
</table>

- $91,150 to $190,150  28%  28%  15%
- $190,150 to $413,350  33%  33%  15%
- $413,350 to $415,050  35%  35%  15%
- $415,050 and over     39.6% 39.6% 20%
Dividends

Dividends are your share of the profit from stock, mutual funds or exchange traded funds (ETFs). They can be paid out in cash or stock and can range from small quarterly payments to amounts that can support a large investor’s lavish lifestyle.

Dividends are taxed at different rates, depending on the type of dividends you get: qualified or ordinary (or nonqualified), in the eyes of the IRS:

- Qualified dividends are most common – the type of dividends paid out by corporations, such as most dividends on corporate stock. Your qualified dividends are taxed at the lower long-term capital gains rate, 15% for most taxpayers.

- Qualified dividends have to meet the 60-day rule: You must hold the stock for more than 60 days during the 120-day period beginning 60 days before the so-called ex-dividend date. (The ex-dividend date is the first day after a dividend has been paid and processed.)

- Ordinary, or unqualified dividends, are taxed at the higher ordinary income tax rate. These dividends may not have met the 60-day rule or they come from unqualified sources,
such as dividends paid out by real estate investment trusts (REITS).

In other words, if you get a dividend from a corporate stock and you meet the holding period, that dividend is *qualified* and gets the lower capital gains tax rate. If you didn’t meet the holding period or the dividends are from one of the unqualified sources, your dividends are *unqualified* and you pay taxes on them at your ordinary income tax rate.

**Example**
Here’s how the impact of qualified vs. unqualified dividends can cut into your returns. You get $4,000 in qualified dividends for the year. Your capital gains rate is 15%. Taxes on your dividend income will cost you $600.

You get $4,000 in unqualified dividends. You are in the 25% tax bracket. You are subject to taxes on the dividends at your ordinary 25% rate. Your taxes on the dividends are $1,000 – $400 more than if the dividends were *qualified*.

**Tax Tip – 60-Day Rule**
Most investors don’t need to worry about qualified and unqualified dividends because dividends they get from corporate stock is generally qualified. But it pays to know how dividends work and the importance of the 60-day rule. The tax implications of your dividend-producing assets can erode your potential returns.
Cost Basis

Your cost basis – what you paid for an investment – is used to determine if you made a profit or loss when you sell, and how much you owe in capital gains.

It can get tricky trying to calculate a cost basis but it’s worth the effort. Seasoned investors know that you can manage the holding periods of your assets -- and your cost basis -- and reduce gains that are subject to taxes.

Your cost basis doesn’t matter if you hold money market funds, for example, where the value of the shares remains constant. But stocks, bonds, mutual funds and ETFs fluctuate in value and can produce both long-term and short-term capital gains, so you’ll need to know your cost basis – what you paid for them – when you sell.

Since 2011, banks and brokers have been required to report the cost basis of your shares, and since 2012 for mutual funds and ETFs. But if you bought them before those dates, you will have to gather your investment statements and records and see what that asset you’re selling actually cost you. Your actual cost is what you originally paid for the asset, plus any related commissions, reinvested dividends, or transaction costs. That’s your cost basis.

Your capital gain is the difference between your cost basis and the proceeds you realize on the sale. Or you may have a capital loss if you sold the shares for less than they cost you.

Your basis matters, especially if your asset has appreciated significantly:
• The lower your basis, the greater your profit and the more you’ll pay in taxes.
• Conversely, the higher your basis, the lower your tax bill will be.

Basis also matters for making smart decisions when you want to sell stock or shares within a fund. Say you buy shares in a mutual fund or ETF at different times and at different prices and then sell only a few shares within the fund. Or you are about to sell shares in a company that you’ve bought many times in the past. You’ll need to know your basis in the shares available to sell to figure out and minimize taxes on them.

Unless you specify to your broker which accounting method to use when you sell a portion of your holdings, the IRS will take matters into its own hands and use the first-in, first-out method (FIFO). That means you’ll be taxed on the earliest shares you bought, which might have a lower basis and therefore create a higher tax bill for you.

But most major brokers have better options than FIFO that may better manage your tax gains.

Example
You bought 500 shares of a company three years ago at $10 a share, and then another 500 shares at $15 two years ago. The shares are now selling at $20 a share. You now want to sell 500 shares. Under the FIFO method, you will have $5,000 in taxable gains (500 x $10, your gain per share). But if you direct your broker to sell your last acquired 500 shares using LIFO, your taxable gains are reduced to $2,500 (500 x $5, your gain per share).
Calculating your basis can get complicated. Here are some special situations.

**Basis of stock that splits.** If a stock splits (issuing more shares), your basis in the shares gets spread across your old and new shares. For example, you own 50 shares in a company that announces a two-for-one split and your basis is $10 per share. You spread your total basis of $500 (50x10) among 100 shares, giving you a basis of $5 per share.

**Reinvested dividends.** Dividends that are reinvested in mutual funds or dividend reinvestment plans to buy other shares are treated as if you had bought the new shares outright at the time of the reinvestment. Some funds track that for you but it’s still wise to hold on to your fund statements so you’ll know your cost basis for each share when you sell. Otherwise, you will have to average out the cost of all your shares, which could result in a higher taxable gain.

**Stock that was a gift.** Your cost basis in stock you received as a gift is the basis of the person who gave the stock to you. However, if the stock has lost value, you use either the previous owner’s basis if you sell the stock at a gain or if you sell at a loss, you use what the stock was worth when it was given to you.

**Stepped-up Basis**

Thanks to a generous provision in the tax code, you could spare your heirs significant taxes on highly-appreciated assets. If you receive appreciated stock as a gift, your cost basis is whatever the stock’s owner paid for it. But, if you inherit the asset, the IRS lets you “step-up” your basis to the day your donor died, giving you a higher basis and reducing your tax liability.
Here’s how it works: Your grandfather left you shares of appreciated stock in his estate. He was clearly a tax-savvy man and here’s why. If he had given you the stock during his lifetime, your cost basis on the gift is the price he paid for the stock. In that scenario, along with his gift of greatly appreciated stock, depending on your tax bracket, he could be saddling you with a huge capital gains tax bill.

But as an heir, your basis is its fair market price on the day your grandfather died. Say he originally paid $50,000 for the stock, and it had doubled by the day he died, your stepped-up cost basis would be $100,000. When you sell the stock, you owe taxes only on any capital gains over $100,000.

**Tax Tip – Stepped-up Basis**

If you’re sitting on big gains – whether it’s appreciated securities or a house – and won’t need the money, it may be wiser to hold onto the asset and leave it as part of your estate. As an inheritance, your heirs can sell at a higher cost basis, minimizing their capital gains taxes. It’s a strategy worth discussing with an estate professional.

**Capital Gains**

As we’ve discussed in this chapter, capital gains on investments can be tax-free for some investors and cut into the investment returns of others in a big way. Here are some steps that might help you limit the amount of capital gains taxes you pay.
Tax Tip – Health Savings Account (HSA)
You can get tax-free growth and bypass capital gains taxes by contributing to an HSA. You get a tax deduction for your contribution and don’t pay taxes on the money until you withdraw it for certain health expenses. (See Chapter 7)

Tax Tip – IRA and 401k
Say you’re at the peak of your earning years and in a high tax bracket, you can reduce your income and cut your capital gains by putting money into one of these tax-deferred accounts. When you start withdrawing at retirement, you’ll most likely be in a lower tax bracket.

Tax Tip – Gift an Asset
Consider giving away appreciated securities to family members who are in a lower tax bracket. They will generally use your basis in the stock and, depending on their tax bracket, could pay nothing in taxes, or pay capital gains taxes but at a lower tax rate than yours.

Tax Tip – Donate an Asset
When you donate your appreciated stock to a charity, you get the tax deduction for the full appreciated value of the stock, and neither you nor the charity pays capital gains taxes.

Example
Five years ago, you bought 10 shares in a company for $10, for a total investment of $100. The shares are now worth $20 each, so the value of your investment has increased to $200. You donate the shares to your favorite charity. Your charity receives a $200 donation and you are entitled to a charitable deduction of $200. Neither you nor the charity has to pay capital gains tax on the $100 gain in your shares.
**Capital Losses**

Even in a bull market a portfolio is bound to have a few losers. As with capital gains, any capital losses you show from selling a losing stock or similar asset can be a short-term loss or a long-term loss. The same time conditions apply:

- You have a *short-term* capital loss if you sell an asset after owning it for less than one year and you get less than you paid for it.

- You have a *long-term* capital loss if you sell an asset after owning it for at least one year and get less than you paid for it.

The tax code helps you out by allowing you to use your loss to offset your gains. You can use your losses to offset capital gains of the same type: use your short-term losses to reduce your short-term gains and long-term losses against long-term gains. Net losses of either kind are then deducted against the other kind.

If your capital losses are still greater than your gains, you are allowed to use up to $3,000 of the capital losses to offset your ordinary income, which includes salary and interest income.

You can carry forward any remaining losses and use them against your gains in the future until you use them up.

Caveat: If you sell a security at a loss and do *not* wait at least 30 days to buy the same security or a “substantially equal” one, you
will trigger the wash sale rule, which disallows your loss. (See Chapter 4 for details on the wash sale rule.)

Examples

**Short and long-term losses.** Two years ago, you bought shares in two companies, A and B. You sell both stocks and gain $2,000 in company A and lose $1,000 in company B. You subtract your loss from your gain and you have $1,000 in long-term gains.

Then nine months ago, you bought shares in companies C and D. They did not perform well so you decide to sell them. Say you realize a $500 loss in C and a $150 gain in D. You subtract the short-term gain of $150 from your short-term loss and you have a $350 short-term loss. Finally, you subtract your short-term loss ($350) from your long-term gains ($1,000) and you get $650 in long-term gains.

**Taking the $3,000 deduction.** If you’re in the 25% tax bracket and you have a capital loss of $18,000 in one year, you are allowed to take a $3,000 deduction for that year and for each of the next 5 years until you total $18,000. In the 25% tax bracket, a $3,000 deduction against your income can be worth $750 a year.

**Tax Tip – Harvest Losses**

Harvesting your losses by strategically selling your losing assets can be an important tool in improving the overall performance of your portfolio. This strategy is discussed in greater detail in Chapter 4.
**Tax Tip – Cost Basis**
If you have losing shares of stock in your portfolio, consider selling the shares that have the highest basis. That way you’ll maximize your losses.

**Tax Tip – Offset Short-Term Gains or Ordinary Income**
It generally makes more sense to use your net losses to offset short-term gains or ordinary income, rather than offsetting long-term gains with your short-term losses. Why? Because short-term gains and ordinary income are taxed at the higher ordinary income tax rate, while your long-term gains get the lower capital gains tax rate.

**Tax Tip – Deduct Worthless Stock**
Sometimes a company stock becomes worthless, that is, has zero market value. You might be able to take a loss for worthless securities. For tax purposes, the last day of the year that they became worthless is the date you use to determine if you have a long-term or short-term loss. If you’re not sure that the stock is really worthless, you can declare the loss and then the following year if it recovers some of its value, you can file an amended return.

**Tax Tip – The IRS Giveth and Taketh Away**
If your spouse dies, as a surviving spouse you can only use inherited losses in the year of his or her death. The losses cannot be carried forward for future use.

**Tax Tip – Harvest Stocks**
Using individual stocks rather than funds can increase your tax-loss harvesting opportunities.
Exception: If you sell your home for less than you paid for it, you cannot deduct the loss against your income – you simply absorb the loss. However, if you show a loss on investment property, such as a condo or second home that you rent out, you can use your losses to offset your investment gains. (See Chapter 5)

The Alternative Minimum Tax (AMT)

The alternative minimum tax (AMT) is not a different tax option, as the name suggests. It’s a kind of parallel tax system that operates alongside the regular income tax. Get caught up in the AMT and you could be adding thousands of dollars to your tax bill.

To understand the AMT, it helps to understand its origins. The AMT has been around since 1969, when Congress noticed that 155 taxpayers with incomes above $200,000 (rich for the times) had paid no federal income tax that year, thanks to legal tax breaks and loopholes.

Congress came up with the AMT to make sure the rich paid at least some taxes. But for many years, the AMT wasn’t tied to inflation – as the regular income tax is – so as taxpayer incomes rose, more and more middle-income taxpayers were swept into the AMT net. Between 2000 and 2005, the ranks of taxpayers subject to the AMT jumped from 1.5 million to 4.6 million, according to the Tax Policy Center.

Congress finally decided to automatically adjust AMT exemptions for inflation in 2012. Still, about 4.8 million taxpayers will pay the AMT in 2016 – with an average bill between $2,000 and $15,000.
The AMT is its own shadow tax system, with its own brackets, rates and rules. A big difference between the AMT and the regular tax system is that many deductions and exclusions are not allowed in the AMT.

That’s why it doesn’t take much to trigger the AMT tax. Generally, if you’re at either extreme of the income spectrum, you might escape the AMT. Low income taxpayers don’t make enough and those in the highest bracket (39.6 %) are most likely already paying more under the ordinary income tax system. But if you make more than $100,000 you should calculate your AMT, and if you paid the AMT in a previous year, you’ll most likely be a candidate again.

Making the AMT calculation is a tedious job. The rules are confusing and you basically have to do your taxes twice – once under the regular income tax regime and again under AMT rules – to see which is higher.

But if you really want to run the numbers yourself, you’ll have to fill out Form 6251 (60 lines of computation). You start by putting back many of the deductions and income exclusions you took on the regular income tax return.

Here are some of the deductions you can’t take when calculating the AMT:

- Personal exemptions for children
- Deductions for medical expenses
- Deductions for state and local income taxes
- Deductions for real estate and property taxes
- A deduction for a home equity loan that was not used for house-related purposes
• Miscellaneous deductions, such as unreimbursed work-related business expenses
• Certain tax-exempt interest
• Certain incentive stock option benefits

Two deductions alone – the dependent exemption for children and state and local tax deductions – are responsible for putting huge numbers of taxpayers at risk for the AMT. In fact, if just those two items were allowed, the number of taxpayers subject to the AMT would shrink from 4.8 million to just 525,000 in 2017, according to the Tax Policy Center. But at the moment, this is not the case.

There is some mercy in the AMT tax code, however. You are allowed an exemption – a special deduction similar to the standard deduction in the regular income tax – that reduces your AMT taxable income.

The exemption amounts for 2016, as the table below shows, are:

- $53,900 (single and head of household)
- $83,800 (married filing jointly)
- $41,900 (married filing separately)

The exemptions start phasing out at $119,700 for singles and $159,700 for married couples filing jointly, at the rate of 25 cents for every dollar of AMT taxable income above these thresholds.

Your next step in the AMT calculation is to deduct your exemption. The result is the amount subject to the AMT rates – 26% on your first $186,300 of income, if you are married filing jointly, and 28% on the rest. But in the income range where the exemption amounts start phasing out, your effective marginal tax rate is about 35%.
The result of this calculation is what you owe in the AMT. Now compare this figure to your regular income taxes. If your regular tax amount is higher, you don’t pay the AMT.

But if the AMT calculation is higher, you pay the difference between the two amounts – on top of your regular income tax bill.

**Example**
You owe $50,000 in regular income taxes. You complete Form 6251 and find you owe $62,000 in the AMT. You have to pay an AMT of $12,000 – on top of your $50,000 in regular income tax.

### AMT Thresholds and Exemptions for 2016

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>AMT Exemption Amount</th>
<th>Excess Taxable Income Rate of 28% (AMTI)</th>
<th>AMT Phase-out Income Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$53,900</td>
<td>$186,300</td>
<td>$119,700-$335,300</td>
</tr>
<tr>
<td>Joint</td>
<td>$83,800</td>
<td>$186,300</td>
<td>$159,700-$494,900</td>
</tr>
<tr>
<td>Married Filing Separately</td>
<td>$41,900</td>
<td>$93,150</td>
<td>$79,450-$247-450</td>
</tr>
</tbody>
</table>
It’s hard to avoid your AMT exposure, short of settling for a lower income. But you can try a number of small strategies to limit it.

- Reduce your adjusted gross income by pumping money into a retirement plan like a 401k.

- Sign up for a pre-tax medical deduction plan if your employer offers one – you’ll reduce both your AMT and your regular tax.

- Miscellaneous itemized deductions, such as work-related employee business expenses that aren’t covered by your employer, are not allowed in calculating the AMT. It may be worth asking your employer to reimburse you directly for those expenses.

- Interest on home equity loans is only deductible if the loan was used to buy, build, or improve your home. It makes little sense to use the loan to finance a car, for example, when you might get a car loan at a lower interest rate.

- Pay your real estate and property taxes when they are due instead of prepaying them at the end of the year. That will help keep your state and local taxes as low as possible.

**Net Investment Income Tax**

The sheer reach of the alternative minimum tax puts it in the top position among “stealth” taxes, but the newer net investment income tax is quickly closing in. The net investment income tax (NIIT) is another tax aimed at the rich. The NIIT was enacted by Congress in 2013, as a way to help fund the Affordable Care Act but, like the AMT, its fate is also uncertain in the current
Congress. If you’re subject to the NIIT, you will pay an extra 3.8% in taxes – on top of your regular income taxes.

Here’s how to figure your net investment income.

- Add your income from investments, including: interest, dividends, long and short-term capital gains, rental income, royalty income, business income from a passive partnership, gains of the sale of your home above $250,000 (single) or $500,000 (married).

- Subtract certain expenses such as those related to rental and royalty income, brokerage fees, state and local taxes on the investment income and a few other miscellaneous fees.

- Now look at whichever is less – your net investment income or the amount by which your modified adjusted gross income is above $250,000 if you’re married and filing jointly, and $200,000 if you’re single.

- Take 3.8% of the lesser amount. That’s your NIIT, which you add directly onto your regular tax bill.

**Example 1**
You’re single and make $180,000 and received $15,000 in dividends and capital gains. Say your modified adjusted gross income is $195,000. That’s $5,000 below the $200,000 threshold. You don’t pay the net investment income tax.

**Example 2**
You’re single and make $180,000 and received $90,000 from a passive partnership interest, which is considered net investment income. Your modified adjusted gross income is $270,000. You are
over the $200,000 threshold by $70,000. You owe $2,660 ($70,000 \times 3.8\%) in taxes on top of the amount you owe in the regular income tax.

Once you’re in the higher tax brackets, it’s not easy to escape this tax without some careful planning. The goal is to keep your modified adjusted gross income below your threshold amount. These strategies could help you reach that goal:

- **Tax-exempt municipal bonds.** They reduce your net investment income tax and modified adjusted gross income.

- **Tax-deferred annuities.** Earnings are not taxed until you withdraw them.

- **Roth IRA conversions.** The distribution you get in the year you convert to a Roth is included in the net investment tax calculation. One way to minimize the effect of this may be to spread conversions to Roth IRAs over a number of years. (See Chapter 3)

- **Charitable contributions.** Donate your appreciated securities that you’ve held for more than one year to your favorite charity. You may avoid tax on the gains and also take a deduction.

- **Rental income.** Your income can be offset by your depreciation deductions. (See Chapter 5)
TAX-FAVORED SAVINGS PLANS
So many retirement accounts, so little time.

Rule #1 for growing your retirement fund is: The earlier you start saving, the more your money grows, and the better you’ll feel about your financial future.

But, the rule seems to be falling on deaf ears. More than half of Americans have no retirement savings or have put aside less than $10,000, according to a 2016 study by GoBankingRates. The only slightly better news is that a diligent 13% have saved up $300,000 or more and the remaining 30% fall somewhere in between.
Some retirees – particularly older ones – may be lucky enough to still have an often generous, employer-provided pension to live on. These plans, known as “defined benefit” plans, are increasingly a vestige of the past. Ever since the mid-1980s the burden of providing for your retirement has shifted from a company (where you may have worked for your entire career) directly to you.

These days, most companies help by setting up retirement accounts to which you can contribute some of your earnings and, in many cases, employers may even offer to match your contribution. The tax laws also help by providing tax incentives for you to participate in a retirement plan. But the responsibility for putting money into the plan and picking appropriate investments lies largely with you.

Since saving for retirement is in your own hands, it’s critical to know which of the various retirement accounts are best for you, and if you have a retirement plan at work, what your tax implications are.

Rule #2 in considering your retirement savings and planning is: Taxes matter. Tax considerations are often an important part—but the most important part is to start funding your accounts as early as possible.

This chapter looks at some popular tax-advantaged retirement plans. Each has its benefits and pitfalls and each can have different tax implications. The retirement plans generally fall into two categories:

- Tax deferred accounts, such as IRAs and 401k’s, and
- Tax exempt accounts, such as Roth IRAs and Roth 401k’s.
The beauty of both these kinds of accounts is that you don’t pay taxes on your earnings every year, as you do with taxable accounts. Managed well, your money compounds over time until you take it out. Some of the accounts give you the tax advantage of taking a deduction for your contribution, if you meet certain qualifications. Some are tax free when you take out your money.

But there are yearly limits to how much you can contribute to each kind of account and when you can start taking money out without suffering penalties. All of this is explained in this chapter.

**Traditional IRA (Individual Retirement Account)**

These simple traditional retirement accounts are the core of many people’s retirement savings. An act of Congress created IRAs in 1974 to help taxpayers save for their own retirement, as it became apparent that workers could no longer rely on company pensions to support their later years.

The government gives you an incentive to put money in the plans by letting you take a deduction for your contributions, if you meet certain conditions. IRAs also allow you to put off paying taxes until you take your money out, sheltering your contributions and allowing them to grow until retirement.

You have to meet several conditions to contribute to an IRA:

- You or your spouse must earn an income – earned income means taxable wages (including tips, commissions, bonuses, net earnings from self-employment and taxable alimony). Earned income does not include – investment income such as dividends or interest, deferred
compensation, pensions or annuities, unemployment compensation or some income earned abroad.

- You must be under age 70½.
- You must make your contribution in cash, check or a direct transfer from a savings account.

And there are limits to how much you can contribute:

1. The maximum you can contribute into a traditional IRA for 2016 is $5,500 if you’re younger than 50 and $6,500 if you’re older.

2. If you’re married, you can each contribute up to the individual maximum.

3. If you make less than $5,500, your limit is what you earned for the year.

**Example 1**
You’re a college student, single and working part-time. You made $3,500 in earnings in 2016. You can contribute $3,500 to an IRA, the full amount of what you made.

**Example 2**
You’re 52 and don’t work but your spouse does. Your spouse can contribute $6,500 to your IRA for 2016 – the $5,500 limit, plus $1,000 since you’re over 50. Your spouse can also contribute to her own IRA. If your spouse doesn’t work but you do, you can still open up an IRA in your spouse’s name. These are commonly called Spousal IRAs. Congress wisely and magnanimously decided that a married couple with only one
spouse working should get the same opportunities to contribute to IRAs as a couple with both spouses working.

**Tax Tip – Start Early**
By putting money into your IRA when you’re young, you’re doubly rewarded by time and the power of compounding. Consider this: Investors who started saving in their early 20s need to save 10% to 12% of their annual income to live their comfortable lifestyle at age 65. Those who started in their 40s, however, may need to save around 25% to get the same amount at 65.

Even if you meet the conditions for contributing to an IRA you still have another hurdle to jump – when are your contributions deductible?

Your contributions are fully deductible, unless you or your spouse has a 401k or other retirement plan at work. In that case, your contribution deduction may be limited or phased out, depending on your modified adjusted gross income. (You can find a precise definition of modified adjusted gross income and what it includes for these purposes at: [www.irs.gov/pub/irs-pdf/p590a.pdf](http://www.irs.gov/pub/irs-pdf/p590a.pdf) (page 14).

Let’s consider different scenarios, using 2016 amounts.

- You’re single and aren’t covered by a retirement account at work. You can deduct the entire amount of your IRA contributions from your income taxes.

- You’re single and are covered by a plan at work. You can take the full deduction only if your modified adjusted
gross income is under $61,000. Above that you get partial
deductions until you hit the phase-out level of more than
$71,000.

- What if you and your spouse are covered by an employer
retirement plan? You can take the full deduction, if you file
a joint tax return, and your modified adjusted gross
income is less than $98,000. Beyond that you get a partial
deduction and no deduction at all if your modified
adjusted gross income is above $118,000.

- What if you’re not covered by a workplace plan but your
spouse is? You can take the full deduction if you file jointly
and your modified adjusted gross income is below
$184,000. Above that amount, you get a partial deduction.
If your modified adjusted gross income is more than $194,
000, you get no deduction.

**Tax Tip – Max Out Your IRA**
At the end of the year, check your IRA and, depending on your
income, see if it makes sense to make any further contributions
if you haven’t already maxed out. Remember that you can
contribute to your IRA account up until the tax filing deadline –
April 18, 2017, for the 2016 tax year. That date is final, though,
even if you file for an extension on your tax return.

You have a lot of control and discretion in deciding what assets
to hold in your IRA account. For example, you can hold stocks or
bonds in an IRA or pretty much anything else—with some
exceptions:
• You generally cannot invest in collectibles with your IRA money. Collectibles include: antiques, art works, coins, gems, guns, metals (other than gold, silver, platinum or palladium bullion held by your IRA trustee), and stamps.

• Real estate is tricky. While you can own real estate in an IRA, you must do it through a self-directed IRA (one that you control), if it allows a real estate investment. And you cannot mortgage your property. If you are considering holding real estate in your IRA, it’s best to get professional advice.

**Tax Tip – IRA Income Is Not Taxed Today**
If you hold a stock that is paying a hefty dividend, by owning it in an IRA it will *not* be subject to current tax, so the full amount can be re-invested. If the dividend was paid to you outside of your IRA, the dividend income would be taxable the year it was issued.

**Tax Tip – Put Higher-Yield Assets in Your IRA**
Because taxes on your gains in an IRA are tax deferred, consider placing assets that distribute lots of gains into your IRA. That strategy may help improve your overall returns.

Once you put money into a traditional IRA, unless there’s an urgent reason to withdraw it before you turn 59 ½, you likely want to avoid doing so. Here’s why:

• IRAs defer your tax liability until you take money out but if you withdraw money *before* you turn 59 ½, you pay tax on the amount you withdrew from the account, as you
would in any case. But you’ll be hit with a 10% penalty for withdrawing the money early.

- Whenever you withdraw funds from your IRA account, whether it’s before or after you turn 59 ½, the money is taxed as ordinary income – not at a lower capital gains rate.

The tax laws do offer some exceptions if you need to withdraw funds from your IRA before you reach 59 ½. If you meet one of the following conditions, you can avoid paying the 10% early distribution penalty:

- You become disabled
- You use the money to pay medical expenses above 10% of your adjusted gross income.
- You use the money to pay higher education expenses.
- You take out no more than $10,000 and use the funds to pay for home-buying expenses on your first home.

A few other less common exceptions apply and if you need to withdraw your IRA funds before you’re 59 ½, check the complete list on the IRS website. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions](http://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions)

When you open an IRA, you complete a beneficiary designation form, naming the person or persons you want to receive the IRA on your death. Be sure to amend the beneficiary designation form when major life events occur, such as a divorce, for example. Otherwise, your ex-spouse, say, might get your IRA whether or not you intended to leave it to him or her.

If you inherit an IRA from your deceased spouse, you can designate yourself as the account holder and make contributions
as if it were your own IRA or you can roll it over into your IRA or into a qualified employee plan.

**Tax Tip – Excess Contributions**
What happens if you contribute more that the limit to your IRA? Excess contributions will be taxed – at 6% per year – as long as you keep the excess amounts in your plan. So, if you contributed $1,000 above your limit, you will owe $60 every year until you correct the error. To avoid this tax, withdraw the excess amount from your IRA, as well as any income you earned on the excess. You’ll have to pay tax on the earnings at your ordinary income tax rate.

**Roth IRA**
Investing in a Roth IRA may be one of the wisest tax decisions you can make to build your nest egg. Consider this:

- You can contribute to a Roth IRA at any age as long as you have earned income from a job.

- Even though you can’t deduct your contributions, your gains are tax-free if you meet certain conditions, explained below.

- Your contributions are *your* money – you can withdraw them (but not necessarily your earnings) any time, tax free and penalty free.

- You can leave your Roth IRA to your heirs tax-free
• There are no minimum mandatory withdrawals at 70 ½, as in traditional IRAs

Like traditional IRAs, setting up Roth IRAs is easily done. You make your contribution by check, cash or direct transfer from your savings account. You can make your 2016 contributions up until April 18, 2017, but no later, even if you get a filing extension.

Your annual limit for contributing to a Roth IRA depends on your filing status and your modified adjusted gross income. Just as with a traditional IRA, your total annual contribution cannot be greater than the income you earned.

You can generally contribute to a Roth IRA if your modified adjusted gross income (in 2016) is less than:

• $183,000 for a married couple filing a joint return.
• $164,000 for singles and married couples filing separately (and you didn’t live with your spouse during the year)
• $10,000 for married couple filing separately (and you lived with your spouse at any time during the year)

The total amount you can contribute to a Roth IRA – and all your IRAs combined for 2016 is:

• $5,500 for 2016, if you are under age 50
• $6,500 if you’re 50 or over
• If you’re married, you can each contribute up to the individual maximum

Here are the key differences between a traditional IRA and a Roth IRA:
• To fund a traditional IRA, you are generally using your pre-tax dollars, while for a Roth IRA you use after-tax dollars. As a reward for contributing after-tax dollars to a Roth IRA, you can take out your contributions at any time without paying taxes or penalties. With a traditional IRA, you have to wait until age 59 ½ to withdraw your money or you incur taxes and a penalty.

• If you have a Roth IRA, you do not have to start taking minimum distributions starting at age 70½. With a traditional IRA, you have to start making minimum distributions at age 70 ½.

• If you have a Roth IRA, your heirs could inherit the funds tax free. In a traditional IRA, you cannot pass the funds on tax-free and your heirs will be subject to income tax on distributions, required distributions and other requirements of the IRA plan.

Gains that you have in a Roth IRA are subject to a few rules. If you are withdrawing funds and also want to take out your gains, you must wait until you turn 59 ½ and you must have held the account for at least five years (for 2016).

After you’ve reached those milestones, funds in a Roth IRA can be withdrawn tax-free. However, if you decide to withdraw gains from a Roth IRA before you are 59 ½ or before the assets have been held for at least 5 years, you could incur taxes on your gains and a 10% penalty on any amount you take out.

As with traditional IRAs, the same exceptions to the 10% penalty for withdrawing your gains early from a Roth IRA apply – becoming disabled or paying for certain educational expenses, for example.
Here’s a quick comparison of traditional and Roth IRAs:

<table>
<thead>
<tr>
<th>Features</th>
<th>Traditional IRA</th>
<th>Roth IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Am I eligible to contribute?</td>
<td>Yes, if you or your spouse have taxable income and are under 70½.</td>
<td>Yes, at any age if you or your spouse have taxable income, and qualifying levels of modified adjusted gross income</td>
</tr>
<tr>
<td>Are my IRA contributions deductible?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>How much can I contribute each year?</td>
<td>The most you can contribute to <em>all</em> your traditional and Roth IRAs is:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• $5,500 (for 2016), $6,500 (50 or older) for singles, or</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Your taxable income for the year, whichever is less.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• $11,000 (married) or $13,000 (both spouses are over 50)</td>
<td></td>
</tr>
<tr>
<td>What is the contribution deadline?</td>
<td>April 18, 2017 for tax year 2016</td>
<td></td>
</tr>
<tr>
<td>What about required minimum distributions?</td>
<td>Yes, when you turn 70½</td>
<td>No</td>
</tr>
</tbody>
</table>
Do I pay taxes on my distributions and withdrawals? Yes, you pay taxes on contributions and conditions earnings you withdraw. If you are under 59 ½ you may get hit with an additional 10% early withdrawal tax.

401k Retirement Accounts

Most private employers currently offer 401k retirement plans, which were first created in the early 1980s as a way to encourage retirement savings. Our advice—and virtually all experts agree—is that if your company offers a 401k retirement plan, you should sign up, and contribute.

Contributing to a 401k may well be the easiest and least-painful way to build your nest egg. Here’s why:

- Your contribution will be withheld from your paycheck and you (probably) won’t even miss it.
- The IRS looks favorably on 401k’s: contributions are not subject to tax and taxes on any capital gains are deferred.
- Your employer may match your contributions to a 401k up to a certain percentage of your salary, generally between 3% and 6%.
- You’re not limited to making only contributions that your employer will match. You can invest up to $18,000 of your pretax income each year. If you’re at least 50 years old, you can make an additional catch-up contribution of $6,000.
Example
Let’s say you make $50,000 and your employer matches 4% of your salary. If you make a $2,000 contribution and your employer matches it, you will have $4,000 in your 401k for the year. If you don’t make any contribution, you are forfeiting your employer’s $2,000 contribution.

If you assume that the $4,000 grows at a 6% annual rate, thanks to the power of compounding, your initial $2,000 will grow to almost $30,000 in 30 years.

Tax Tip – 401k Match
It almost always pays to contribute at least as much as your employer’s matching contribution level into your 401k. But before you max out, as discussed below, first look at your near-term financial needs and consider which of the investment options available for your 401k meet your immediate needs and retirement goals.

401k plans sponsored by companies generally offer a variety of investment options – like mutual funds, bonds, small cap funds and international funds, for example.

As you consider the choices keep your age and overall investment goals in mind, as well as the tax consequences of your investments.

Younger workers may want to look at investments that generate higher yields and gains, which will grow tax-free and increase the value of your retirement account.
As you get older you may want to consider rebalancing your portfolio to choose safer investments that might better preserve your capital.

No matter what your age, watch out for fees in 401k plans. The cost of fees can significantly drag down the return on your retirement investments. Some plans have only a limited choice of funds, but if possible, a good choice is to go with index-based funds, which generally charge lower fees than other types of mutual funds.

One type of retirement plan, typically offered to teachers and employees of some non-profit organizations, is known as a 403b plan, named after the section of the law that created it. Be especially wary when choosing your investment options in these plans. The plans often carry a heavy mix of insurance products, and along with them, notoriously high fees. Thrift Saving Plans, on the other hand, which are offered to federal government workers, generally have comparatively low fees.

As with many retirement plans you can generally start taking penalty-free withdrawals from your 401k at age 59½. One exception is the rule of “55.” If you retire, quit or are let go from your job and you are 55 years old, you can withdraw funds from your 401k without penalty. But any sooner and you are likely to face a 10% penalty tax.

As in a traditional IRA, with a 401k plan once you turn 70 ½, you will have to make required minimum distributions each year. If you have both a traditional IRA and 401k, you’ll have to make the required withdrawal from each account.

You can take your 401k plan with you when you switch jobs. You can roll the account over into your new employer’s 401k, if
the plan allows, or you can roll it into your own IRA. A cautionary note: You have 60 days to do the rollover or the amount will be taxed as ordinary income. (See more below on rollovers.)

**Roth 401k**

Whether you’re covered by a retirement plan at work or are self-employed, you can also take advantage of putting your after-tax money into a so-called Designated Roth 401k. The plans let your money grow tax-sheltered and provide a tax-free income source when you retire.

For a decade or so, the IRS has allowed retirement plan administrators to create a separate account within a 401k, a 403b for non-profit organizations, or a government 457b plan, to hold designated Roth contributions, and many retirement plans now offer it. You have the option of deciding to make contributions to each or both accounts.

Here are the tax benefits of a Roth 401k:

- You pay contributions to the plan on an after-tax basis and when you take out your contributions you pay no taxes on them.
- There are no income limits in a Roth 401k as in Roth IRAs.
- You can take out your contributions and earnings tax-free at age 59½, as long as you have held the account for 5 years. Your distributions do not count in the formula for determining how much of your Social Security benefits are taxable.
- You pass on your Roth account tax-free to your beneficiaries.
Employee contributions to a Roth 401k, as in traditional pre-tax 401k accounts, are limited to $18,000 in 2016 and 2017, plus an additional $6,000 if you are 50 or older at the end of the year.

Just as in a regular 401k, in a Roth 401k you’ll have to make minimum distributions, that is, withdraw some of your money at age 70 ½, even if you don’t need the income at that time.

Not all employers offer Roth 401k because of the heavy paperwork requirements. But if it’s available to you or if you are self-employed, you should consider how the tax benefits can help you.

If you’re a younger worker, for example, contributing to a Roth 401k can be a smart choice, assuming you are in a lower tax bracket but expect to be at a higher bracket later. Paying the tax upfront can be a good strategy. You watch your money grow tax deferred, and as in a Roth IRA, the savings will be tax-free when you withdraw in retirement.

On the other hand, if you are a higher-income worker, you may prefer a traditional 401k plan – assuming you are now in a higher tax bracket, but expect to be in a lower bracket in your retirement years, when the money will be taxed at a lower rate.

**SEP IRA**

A Simplified Employee Pension Plan (SEP) is a tax-deferred retirement plan for a self-employed individual or for a small business, with one or more employees. The plans are easy to set up, have low administrative costs and have flexible annual contributions, if cash flow is an issue, for example.
Here’s how it works. You set up individual IRAs for yourself and your employees, with their names on the accounts. But, you make the contributions — your employees cannot.

Any contributions you make are tax-deductible as an adjustment to your income (contributions don’t reduce your self-employment tax for Social Security and Medicare).

The limits on your contributions are more generous in an SEP IRA than in traditional or Roth IRAs. As a self-employed worker, you can contribute as much as 25% of your net earnings from your self-employment income, up to $53,000 for 2016 ($54,000 for 2017).

In addition, you — and your employees, if you have any -- can still make contributions to a traditional or Roth IRA.

Here’s where the plans are flexible: You don’t have to make contributions every year. But when you do, you’ll have to contribute both to your own SEP IRA and to those of all your eligible employees. (Any employee who is over 21, makes more than $600, and has been with the company for three of five years is eligible.)

**Tax Tip – Filing Deadlines**

You get a little extra time to set up and fund a plan — as late as April 18, 2017 or October 15, 2017 if you get a filing extension — and still get a tax reduction for 2016. By comparison, with a Solo 401k, discussed below, you can only contribute to a plan that was set up during the tax year. The longer time window lets you make decisions based on a pretty good picture of your previous year’s finances.


SIMPLE IRA

Another option for the self-employed and small business owners is the so-called SIMPLE IRA or Savings Incentive Match Plan for Employees. It’s basically a big IRA, and like most IRAs, your contributions may be tax deductible and your assets grow tax-deferred until you take them out in retirement.

In a SIMPLE IRA, there are two contribution levels:

- As an employee, who earned more than $5,000 for the year, you can contribute 100% of your salary up to $12,500 (for 2016 and 2017), and up to $15,500 if you’re over 50.

- As an employer, you make a 3% matching contribution or a flat 2% non-elective contribution. All employees must get the same level of contribution.

- As an employer, you can lower the matching contribution to 1% or 2% of salary in any two out of five years that you have the plan. But in the other three years must go back to a 3% match or the flat 2%.

SIMPLE IRAs are fairly easy to set up and cheaper to manage than some other workplace retirement plans, such as profit-sharing plans and 401k’s. SIMPLE IRAs can also be more hassle-free than SEP IRAs, which can become complicated when you add on employees. You must set up a SIMPLE IRA, however, before October 1 of the tax year in which it is going to be in effect.
**Solo 401k**

One-participant retirement plans – sometimes called a Solo 401k or individual 401k – are strictly for the self-employed who have no employees. However, your spouse can contribute if he or she also earns money from your business. It’s a great way to defer taxes on your income until you withdraw funds at retirement, when you could be in a lower tax bracket.

However, it may require more paperwork on your part to administer these accounts. If your account exceeds a certain amount, you may have to file a special tax return. Fees that financial or accounting firms charge to open up and manage an account can vary widely, so be sure to shop around.

Aside from these administrative chores, if you want to put large amounts away for retirement, these accounts are a better option than an SEP IRA — largely because more money can be socked away.

A Solo 401k lets you be the boss and the employee, allowing you to contribute more than you might in an IRA or SEP IRA:

- As an owner, you can take elective deferral up to your entire earned income as a self-employed individual up to these limits: $18,000 for 2016 and 2017, and $24,000 if you’re 50 or over.

- As the employer, you can contribute up to: 25% of your compensation, as defined by the plan to a maximum of $53,000 for 2016 ($54,000 for 2017) if you’re under 50, and $59,000 (2016) and $60,000 (2017) if you are 50 or older.
• If your spouse is also in the plan, together you can contribute up to $108,000, and if you are both over 50, an additional $12,000 in catch-up contributions – for a grand total of $120,000. Quite a tidy sum to sock away each year.

**Example**
You are 51 and earned $50,000 in wages from your S Corporation in 2016. You deferred $18,000 in regular elective deferrals, plus $6,000 in catch-up contributions to your Solo 401k. Your business contributed 25% of your compensation to the plan, $12,500. Your total contributions for 2016 were $36,500. This is the maximum that you can contribute for 2016.

Solo 401k’s are attractive for a number of reasons:

• Contributions to the plan are tax-deductible.

• Contributions are not mandatory each year. You can max out in a blockbuster year and hold off on contributions in not-so-good times.

• There are no income restrictions as there are with some other plans – you can contribute no matter what your income level.

• Maybe most important, you have complete control over investment decisions, and therefore can make choices that can lower your tax bill.

One unique feature of the Solo 401k is that, unlike SEP IRAs, you can take a loan from the accrued savings you have in the
account, if your plan permits. Your loan can be for up to 50% of your total balance, or $50,000, whichever is less.

The interest rate is low: at the prime interest rate plus 1%. In some cases, you may be better off taking a loan, rather than withdrawing early and likely paying a penalty.

One caveat with Solo 401k’s is that, as with many retirement accounts, if you withdraw funds before 59 ½ you’ll have to pay taxes on the amount, and most likely have to pay the 10% penalty.

**Tax Tip – Borrowing Against a Solo 401k**
Before borrowing against your Solo 401k, you should first consider any lost investment opportunity from withdrawing the money from your account. Also, be sure to repay your loan within a five-year period, the time required by law. Otherwise, any unpaid portion of your loan will be treated as a withdrawal for tax purposes.

**Rollover IRA**

When you change jobs or retire, consider rolling over your retirement savings account, such as your 401k or 403b, to an IRA or your new employer’s 401k – assuming you think it’s a good one.

A so-called “rollover IRA” is simply an IRA set up to receive your money from a retirement plan. You won’t have to pay tax on the rolled over assets, and your money will continue to grow tax-deferred.
Be sure to consider the benefits of your receiving account. You may find that rolling over into an IRA gives you greater flexibility and control over how you want to allocate your retirement assets.

Here are the important rules for rollovers:

- A rollover into an IRA has to be completed within 60 days from the day you get your distribution.

- If not, the rollover amount will be taxable and you may also get hit with a 10% additional tax on early distributions.

To be sure you meet the deadline, have your financial institution or old plan transfer the payment directly to your IRA or any new plan. If the plan administrator is writing you a check for the rollover amount, be sure it’s payable to your new plan or IRA, otherwise the amount could be subject to mandatory withholding of 20%.

When you’re planning a rollover, watch out for another IRA rollover rule.

- You can make only one rollover from an IRA to another (or the same) IRA in any 12-month period, regardless of the number of IRAs you own.

- This one-per year limit does not apply, though, if you roll the money over from traditional IRAs to Roth IRAs (conversions), as we see below.
**Tax Tip – Rollover to a Roth IRA**

Although you can rollover your money from a traditional 401k to a Roth IRA, the IRS will treat it as a so-called Roth conversion and the amount converted will be taxed as ordinary income. Nevertheless, as discussed below, that too may be a smart move, depending on your financial situation.

Roth IRAs can be a great way to help fund your retirement and shield your income from taxes. The trade-off is that you’re using after-tax dollars to fund the account.

Even so, that trade off may be worth it because you reap the rewards of compounding over time, and you pay no income tax when you withdraw the funds in retirement.

In addition, there are no income restrictions on converting from a traditional IRA to a Roth IRA. It’s only been about seven years since income restrictions were lifted on making the conversion. Before then if you had a modified gross income of more than $100,000, you couldn’t make the conversion.

Once the income lid was removed, according to an IRS report, funds converted to Roth IRAs spiked 800 percent to $64.8 billion in 2010. Most of those who converted were in higher income brackets – and more than 10% had an income of $1 million or more. They were also youngish: 65% percent were under 60, and 41% were under 50.

Deciding whether to convert from a traditional to a Roth is the big question and, as is often the case, taxes play a major role. First of all, converting to a Roth comes with its own tax implications.
Unlike traditional IRAs, Roth IRAs are funded with after-tax money. So when you convert from an IRA to a Roth IRA there is a tax consequence in the year that you switch over to a Roth IRA. The pre-tax amount you convert to a Roth IRA is taxed at your ordinary income tax rates.

Example
You have $10,000 in an IRA from pre-tax contributions that you convert to a Roth IRA. The $10,000 is added to your taxable income for the year, because your contributions to the traditional IRA had been deducted from your taxes in earlier years.

Overall, Roths are a pretty sweet deal but should you make the conversion? There is no universal answer. It could be a smart tax move for some to convert an IRA to a Roth IRA, but not as beneficial to others.

You’ll have to ask yourself a number of questions before deciding if a Roth conversion is right for you. Most important are your time horizons and your future tax rates. Consider these questions:

- You will get socked with a conversion tax at ordinary income rates. Can you afford the tax hit and does it make sense to take it?

- What is your anticipated tax rate in retirement? Do you expect it to be lower than the rate you’re paying now?

- What’s your investing time frame? Is it long enough to benefit from compounding?
Let’s look at who stands to benefit most from a Roth conversion. Younger workers and those with lower incomes may have most to gain from the conversion in the long run:

- Most likely your tax rate is lower now than it will be in the future. So paying taxes for converting to a Roth IRA will cost you less now than if you withdrew the same amount of IRA funds in the future. That’s assuming that your income will grow with time, of course, and that your future tax bracket will be higher.

- Second, the money that you convert now grows tax free in the Roth IRA and remains tax-free when you withdraw it at retirement. The younger you are, the more time it has to grow tax free.

- If you are having a low-income year or are unsure about making a sizable conversion, you might consider a partial Roth conversion – holding onto some assets in traditional IRAs.

The picture is cloudier for those in higher tax brackets (28% and above).

- Converting to a Roth IRA may not be a great tax move if you are in a high bracket now but expect to be in a lower one in the future. You’ll be paying taxes at a higher rate than you might be paying later.

- Wealthier investors might have other strategic reasons for converting to a Roth. Since you don’t have required minimum amounts to withdraw with a Roth, you may
benefit from converting and reducing your tax liability in retirement.

- Converting to a Roth IRA lets you pass on the money to your heirs tax-free. But any beneficiary, other than your spouse, will have to make required minimum withdrawals.

**Tax Tip – How To Pay Roth Conversion Taxes**
It’s wise to pay taxes for a Roth IRA conversion with money not from your retirement account. Otherwise, you may lose the benefits of the tax-free growth of your converted amount. If you can’t afford to pay the full conversion from your after-tax money, consider a partial conversion.

A Roth conversion is most easily done when you hold a traditional and Roth IRAs at the same financial institution. You simply ask the trustee to transfer an amount from your traditional IRA to your Roth IRA.

Using a different institution involves a little more paperwork – the distributing trustee will likely issue you a check payable to the new trustee.

If you are only converting a traditional IRA worth $10,000, say, to a Roth IRA – easily done, you pay tax on the $10,000 distribution.

But conversions can get tricky. Say you have another IRA, such as an SEP-IRA or SIMPLE IRA, and you have made after-tax contributions to them – that’s when things get complicated. The IRS wants you to aggregate all your non-Roth IRAs and on a
pro-rata basis calculate the amount of your conversion that will not be taxed.

**Tax Tip – Talk to a Pro**
The devil is in the details when it comes to converting to a Roth IRA. It can get complicated, so the advice of a professional could come in handy.
TAX OPTIMIZATION
How to minimize the taxes on your investments.

Taxes, of course, can have a significant impact on your investments. And what matters most is your after-tax return, the money you keep after you have paid your taxes.

Chapter 1 looked at assets that are generally more tax efficient, such as stocks, passively managed index funds and ETFs, and some that are less so, such as actively managed mutual funds. Chapter 3 discussed tax-deferred accounts, IRAs and 401k’s, and tax-exempt accounts, Roth IRAs and Roth 401k’s, and their various pros and cons from a tax point-of view.
This chapter asks: Where do you put your assets to minimize the tax drag and maximize your after-tax return?

In a way, the old real-estate adage – location, location, location – applies to all investments as well. Looking strategically at places to hold your assets in tax-efficient ways is called *tax location*. Asset *allocation*, on the other hand, is another matter. It refers to which assets to own and in what proportions and is not discussed in this chapter.

Maybe you are currently only putting your money into your tax-advantaged accounts like a 401k or Roth IRA, and watching your assets accumulate. In that case, you don’t need to be overly concerned about tax location, focus instead on asset allocation and selecting your investments.

But if you have a taxable account or multiple accounts, you’ll want to know where to put different assets.

This chapter first discusses the reasons you may want a taxable investment account and then offers strategies for which assets to place in it. It also looks at appropriate assets to place in your tax-deferred or tax-exempt accounts. In the next chapter, we explain the strategy of harvesting your losses – intentionally selling off losing assets to offset the gains in your taxable account.

**Taxable investment accounts**

A regular investment account is labeled taxable but the truth is that no matter which type you choose – taxable, tax-deferred or tax-exempt – the IRS will claim its share at some point. It’s just a matter of when. In a taxable account, you pay taxes on dividends on an annual basis and on your gains when you sell the asset.
A taxable account is easily opened with a brokerage firm by making an initial deposit. You can open it in your name or with another account holder. In a joint account, you are legally equal holders of the assets and you and your joint account holder both have access to the funds.

Here’s why taxable accounts can be attractive:

- **Liquidity.** You can take your money out anytime, for whatever reason, and pay no penalty for withdrawing the funds and possibly no tax on your gains, depending on your bracket. Easy access to your money also makes taxable account appealing for raising the funds for buying a house, taking a vacation, or for life’s unexpected emergencies.

- **Diversification.** You have the opportunity to invest in different asset classes that may not be represented in your retirement accounts. Furthermore, taxable accounts give you the flexibility of rebalancing portfolio as your investment objectives change.

- **Tax advantages.** You get some tax breaks on the dividends and long-term capital gains of certain taxable assets. Earnings are taxed at your ordinary tax rate, but qualified dividends and long-term capital gains are taxed at the lower capital gains rate: 0% to 20%, depending on your tax bracket.

- **Donating.** You can donate appreciated stock to a qualified charity and reduce your taxable income. You can give up to 50% of your adjusted gross income in cash and 20% from appreciated securities to qualified charities each year.
You don’t pay taxes on the gains, nor does the charity. And you can take the deduction on your taxes.

- **Inheritance.** Your appreciated assets in a taxable account can be left to your heirs and they get a special tax benefit on the appreciated gains. That’s because their basis in the securities, or the amount they bought it for, is reset on the day you died. When they sell, they pay taxes only on the appreciated gains from that day. (For more tax strategies in retirement see Chapter 6.)

- **Tax loss harvesting.** As discussed in greater detail below, if you have unrealized losses in your taxable account, you can benefit from the loss through a strategy called tax loss harvesting. For example, you can offset up to $3,000 of your ordinary income with $3,000 of investment losses. By contrast, your losses in tax-deferred or tax-exempt accounts get no tax advantage.

**Tax Location**

The table below shows the most common types of accounts that you can put your investments into: taxable, tax deferred or tax exempt, and which assets to place in each.

This topic can get highly complex but one general rule is that tax-efficient assets should go into taxable accounts. Conversely, your most tax-inefficient assets should go into tax-sheltered places.

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<th>Taxable Accounts</th>
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<td>IRAs, 401k’s</td>
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Your most tax-efficient assets, such as individual stocks, should generally be held in a taxable account. Tax-efficient investments lose less of their return to taxes and offer the benefit of long-term growth. You have the choice to own stocks that pay no dividends and incur no gain, or those that pay little in dividends.

Consider placing exchange traded funds (ETFs) into your taxable account. Most of the gains incurred in an ETF stock index fund, for example, are locked in as capital appreciation. That means some ETFs can go for a long time without making a capital gains distribution and when they do it’s generally not large.

Tax-free municipal bonds should go into your taxable account. The interest paid out is tax-free at the federal level, and possibly at the state level.

Taxable bonds, especially low-yielding bonds, may also have a place in your taxable accounts. Interest on bonds is taxed at a
higher rate than stock dividends but their slower growth can make them good candidates for taxable accounts.

**Example**
You buy low-yield stocks that you chose for their long-term growth potential. You may want to put them in your taxable account. Here’s why. The stocks generally pay small or no quarterly dividends and therefore won’t hike up your taxable income at the end of the year. Hold them for at least one year before you sell and you pay tax on any gain at the lower long-term gain rates. Or, if you have a loss on the stock when you sell it, you can use your loss to offset your long-term gains.

Putting your money into tax-deferred accounts, such as traditional IRAs and 401k’s, nearly always makes good sense. In fact, it’s practically a necessity these days to help secure your financial future in retirement. Unlike in taxable accounts, dividends and capital gains generated in these accounts, especially if they are reinvested, will grow and multiply tax-free until you withdraw the funds. If you participate in a 401k plan at work and you are given investment options, it’s wise to pick those that are expected to generate high annual returns.

Place high-yield stocks and mutual funds in tax-deferred accounts. They can generate dividends and gains that will grow through the power of compounding. Reinvested dividends and gains can produce a higher annualized return over time.

Just as important, gains you realize in high-yield stocks and mutual funds are put off to the future, freeing you of the annual tax bill you get with taxable accounts.
Higher-yielding taxable bond funds can also be good candidates for a tax-deferred account since they generate interest income that is taxed at the higher ordinary income rate.

Real estate investment trusts (REITs) would also belong in your tax-deferred account. REITs are tax-inefficient since dividends from REITs are taxed as ordinary income, rather than at lower capital gains rates. Also, any income generated from a REIT is taxed at the higher ordinary income rate.

**Example**
How your money multiplies in a tax-deferred and tax-exempt account. Say you are 25 years old and you deposit $50 into your tax-advantaged account every month. If you assume a 10% growth rate, by the time you are 65 and ready to retire your contributions to the account will total $24,050. But through the power of compounding your funds will have grown to $325,522.99.

Tax-exempt accounts such as Roth IRAs and Roth 401k’s do not provide an upfront tax break since the funds you contribute to them is after-tax dollars. But they have the unparalleled benefit of letting you take out your money tax-free down the road. In addition, withdrawals from Roth IRAs are not counted as income when you calculate your amount of taxable Social Security income.

Here are some considerations when placing assets into tax-exempt accounts:

- Place higher growth assets into a Roth IRA, where the power of compounding returns can work its magic.
• Consider placing REITs into your Roth IRAs. REITs are tax-inefficient since their dividends do not qualify for the capital gains rate and are taxed at the higher ordinary income rate.

• High-dividend yield taxable bonds (typically over 5%) are taxed at an ordinary income tax rate. Although they are not high-growth assets, in a tax-exempt account, you get to shield their distributions from taxes.

• High-generating income assets, such as REITs and taxable bonds, are also good candidates for tax-exempt accounts because your funds are not subject to required minimum withdrawals, as in tax-deferred accounts. You can decide to withdraw your money without worrying about the tax consequences.
TAX LOSS HARVESTING
How to harvest your losses and defer your gains.

One strategy you can use to bolster your return is known as tax loss harvesting. Here’s how it works: You intentionally sell losing investments, such as individual stocks, ETFs and mutual funds, for example, and use the loss to help boost your after-tax returns. To do this, you’ll need to have a taxable investment account and the strategy works best with a portfolio of individual stocks in which you’re bound to have winners and losers. That way you can offset gains from stocks you opt to sell with losses from stocks that have not fared as well.

Keep in mind that the point of tax loss harvesting is to sell losing stocks temporarily to help reduce your taxes. You may later
want to buy back the stocks to maintain diversity in your portfolio, for example, but if you do, be sure to obey the wash sale rule (discussed below) requiring you to wait 30 days before or after the sale to buy the same security.

When properly managed – and tax loss harvesting does require time and diligence to manage – you stand to reap these benefits. You can:

- Offset your taxable gains with losses.
- Write off $3,000 from your taxable income and carryover your losses.
- Take advantage of the opportunity to rebalance your portfolio by paring down winners to offset losses.
- Defer your capital gains taxes and allow that money to grow and compound.

The idea behind tax-loss harvesting is fairly simply. When you have losses, you first use them to offset similar gains – short-term losses against short-term gains and long-term losses against long term gains you show for the year.

Net losses of either type can then be deducted against the other type of gain. If your losses end up being more than your gains, you can write off up to $3,000 ($1,500 for married filing separately) from your taxable income – including from your salary and interest income, for example.

After deducting $3,000 from your taxable income, if you still have capital losses for the year, you can carry them forward and use them against your capital gains in following years or indefinitely until they’re used up.
Example #1
You have $5,000 in short-term capital losses and $3,000 in long-term capital losses. At the same time, you have $3,000 in short-term capital gains and $4,000 in long-term capital gains. First, you take the $5,000 in short-term losses against the $3,000 in short-term gains. Now you have $2,000 in short-term losses. Apply the $3,000 in long-term capital losses against the $4,000 in long-term capital gains.

Now you have $1,000 left in capital gains and $2,000 left in short-term capital losses. You apply the $2,000 against the $1,000 in capital gains and you have $1,000 in losses that you can use as a deduction against your taxable income. Plus, you’ve paid no capital gains taxes on your gains.

Example #2
You bought a fund for $10,000 in June and it declined to $5,000 four months later. You decide to harvest the loss. It will be considered a short-term loss because you held the fund for less than one year. You apply the loss against your short-term gains. If you are in the 35% tax bracket, that loss could shave $1,750 off your taxes.

Tax Tip – Match Long-Term Losses with Short-Term Gains
Timing is a big factor in tax-loss harvesting. Harvest your long-term losses when you have considerable short-term gains, which are taxed at the higher ordinary income rate. Use the long-term losses to offset those short-term gains and you avoid the higher tax rate on those gains – an especially helpful move for those in the higher income tax brackets.
Tax loss harvesting doesn’t need to be an end-of-the-year only strategy. It’s a good tool to use year-round to spot good tax loss harvesting candidates. And while you’re at it, review the overall portfolio – not just your taxable accounts but your retirement accounts as well – to see if it still meets your investment goals. If you find you are overexposed in one sector, you may want to pare down some of your winners in the taxable account and offset those gains with your harvested losses.

**Tax Tip – Trade in Your Tax-Deferred Accounts**

If you need to sell shares when rebalancing your portfolio, consider first selling shares in tax-advantaged accounts to avoid a taxable transaction. But if all your assets are in your 401k retirement plan, you probably don’t need to stress over tax location. Your main role is to allocate your investments among various assets as chosen by your plan, such as stocks, bonds, index funds.

When you sell a security at a loss, watch out for the “wash sale rule.” Under this regulation, you cannot claim a loss if you buy a “substantially equal” security within 30 days before or after you sell the original one. Steer clear of the rule before buying the same or nearly identical one in any account or the IRS will disallow your loss.

**Example #1**

You sold a losing high-tech stock and now have seller’s remorse. If you purchase the same stock within 30-days before or after you sell it, the IRS will disallow your loss. You can immediately purchase a different high-tech stock, for example, or you can wait at least 31 days to buy the identical stock again.
Example #2
You buy 1,000 shares of a company on April 16 at $30. On May 7, you double up because the share price has dropped to $20. You now have 2,000 shares of the company. On May 18, you sell the first lot at $26. Your $4,000 loss will be disallowed by the IRS because you had purchased the same security 30 days before your sale. However, the loss doesn’t disappear completely – it is added to the basis of the remaining 1,000 shares. If you’re not careful the wash sale rule can catch you in either direction.

Example #3
What is a "substantial identical" security for purpose of the wash sale rule can get tricky once you move away from individual stocks. Say you sold an S&P 500 Index ETF fund from one of your brokerage accounts to claim a loss. You turn around and buy an S&P 500 Index ETF from another provider before 30 days are up. The IRS will disallow the loss because the two funds are substantially identical.

Example #4
You sell off your shares of a technology mutual fund and you buy a technology mutual fund from another provider. It’s unlikely that IRS will consider those two funds to be “substantially similar,” unless both funds carry the identical technology stocks. Or, you could buy a technology exchange traded fund (ETF), a substantially different asset, and not worry about the rule.

An important note: The wash sale rule applies whether you are buying a security in your personal account or in a tax-deferred or tax-exempt account. You can’t take a loss on a security in your taxable account and then buy the same security in your IRA or a Roth IRA unless you follow the 30-day wash sale rule. But you
probably wouldn’t want to re-buy in a tax-advantaged account, anyway. By doing so you would be completely giving up that loss.

**Tax Tip – Wash Sale Gotcha’s**

Don't run afoul of the wash rule if you sell partial shares in a mutual fund at a loss. Keep on top of automatically reinvested dividends in a mutual fund that could unwittingly cause a violation of the wash sale rule or part of your loss will not be allowed.

There are some caveats to tax loss harvesting:

- Keeping track of your gains and losses in your portfolio can be complex. The process of tax loss harvesting requires time, attention to detail and decisions on whether your loss is substantial enough to harvest. There’s also the risk that you’re selling a stock that’s only dipping temporarily and miss out on potentially large gains. Often, tax-loss harvesting is best left to the pros. Their sophisticated techniques can assess tax loss harvesting strategies and the potential effects on your overall portfolio.

- If you use harvesting losses as a tax deferral strategy to offset gains and rebalance your portfolio, you could end up with significant embedded long-term capital gains that can raise your future tax rate. You may want to donate appreciated stock to charity, for example, or pass it down to your heirs – both strategies to limit or avoid the eventual tax bill.
• Tax-loss harvesting is a tool that can help many save tax dollars but the ability for the strategy to provide significant benefits depends on many individual portfolio factors and not every investor will benefit. Still, it’s a strategy that should be considered. The chart below shows how tax loss harvesting can benefit your after-tax returns over time.

![Tax Loss Harvesting Chart]

**Tax Loss Harvesting**

Harvesting losses and deferring gains leads to a higher after-tax return over time.

- Sell losses to offset gains from winners
- Buy diversified ETF to stay invested and avoid wash sale

**Hypothetical Stocks**

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Hypothetical Returns
YOUR HOME
Your home is your castle, and also a tax shelter.

Owning a home has long been part of the American dream and that’s reflected in the tax code. Homeowners are eligible for a bounty of tax breaks that one way or another are designed to encourage home ownership—whether it on your primary residence or a second home at the beach or in the country or anywhere in between. Indeed, for most Americans, their home is their largest and most important lifetime investment.

This chapter looks at tax rules and opportunities at every stage of buying, selling and renting out your property – from deducting mortgage interest and points, to selling or transferring
your property, including the tax perils of buying your ex’s share of the house in a divorce.

**Buying Your Home**

What is a home? This is a basic question: What qualifies as a main home in the eyes of the IRS?

As long as you sleep in it, cook in it and it has bathroom facilities, it’s considered a home for tax purposes. Beyond that, you can get creative: it can be a house, condo, co-operative, mobile home, yacht, recreational vehicle, or even a tree house, as far as the IRS is concerned.

You get more favorable tax treatment on your main home than on a second home – so what counts as your second home? That depends. You can’t choose which residence to call your main home but you get some flexibility on selecting your second home.

If you own multiple homes, you may be able to designate any one of them as your second home.

Next year, you can switch, for example, if you find you get better tax treatment from picking a different second home with larger interest payments to deduct.

Some rules apply. Say you rent out your vacation home for part of the year. To designate it as your second home, you must use it for more than 14 days, or more than 10% of the numbers of days you rented it out (at fair market rent) – whichever number of days is greater.
Deducting Mortgage Interest

You’ve found your dream home, and your mortgage – a loan to help you afford it. Assuming you itemize deductions on your tax return, you get some nice house-warming gifts in the way of tax savings.

One is the deduction of interest you pay on that mortgage every year.

- What’s included in mortgage interest? Any interest you pay on your primary and secondary mortgages, as well as on part of your home equity loans.

- The mortgage interest deduction applies no matter what type of mortgage you get – whether it’s a traditional 30-year fixed rate or an adjustable rate mortgage.

- Only loans secured by your home qualify for the mortgage deduction, not personal loans. Payments on the mortgage principal however cannot be deducted — only the interest you are paying on the loan.

There are limits to the IRS’s largesse. While there’s no cap on the dollar amount of interest you can deduct annually, there is a limit on the size of the mortgage that qualifies for the interest deduction.

Take a look at your so-called acquisition indebtedness, or the financing you used to buy, build or improve your main home. You can deduct the interest on up to $1 million of that total mortgage debt if you are married and filing together and up to $500,000 if you’re filing separately.
Limits are lower for home equity loans. You can deduct interest on principal balances of up to $100,000 (married, filing jointly), and $50,000 if you’re filing separately. Keep in mind that there’s no cap on the dollar amount of interest on your home equity loan that you can deduct, only on the amount you borrow.

Can you deduct mortgage interest you pay for a child? Say that as a parent, you’re also helping out a daughter or son by paying their mortgage – not unusual these days for many parents of kids just starting out. Can you deduct that mortgage interest? Generally, yes, as long as you are the primary borrower of the loan, or you co-signed the mortgage loan.

Tax Tip – Are Payments Interest or Rent?
What happens if you move into your house before the sale is final? Any payments you make are considered rent – you cannot deduct them as interest, even if the settlement papers list them as such.

What about those upfront points (loan origination fees or loan processing fees) that you pay on a mortgage – are they deductible? Generally, yes. But points generated by refinancing an existing mortgage or on a mortgage for a second home or rental property, cannot be deducted immediately. Those points are deducted equally over the life of the loan. (See more in rental properties, below.)

But, you may be able to deduct upfront mortgage points completely if you meet certain conditions:

- Your loan is fully secured by your main home.
• Your down payment for the home is greater than the cost of the points.
• The points you pay are consistent with fees charged in your area.

**Example**
You buy your main home for $350,000. The going rate in your area is 2 points, let’s say. You would pay $7,000 ($350,000 x 2) in points and be immediately eligible to deduct the full amount on your tax return.

**Tax Tip – Deduct the Points**
What happens if the seller pays a portion of your points? The seller can’t deduct his share of the points on his tax return. As the buyer, you deduct both your points and the seller’s portion. This applies even if the seller paid all of the points for you.

The state and local real estate taxes you pay on your main home – and on your vacation home and any other homes you own – are itemized tax deductions. Unlike the mortgage interest rule, there’s no limit on the amount of property taxes you can deduct, and no limit on how many houses for which you can claim the deduction.

**Selling Your Home**

Timing is everything when it comes to selling your house – be sure you don’t sell too soon or you’ll face a sizeable tax bill.

The rules for standard home-sale transactions are simple:
• If you live in your primary residence for two of the five years before you sell it, you may be able to exclude your gains from taxable income.

• If you’re single, any profit you make on the sale of your main home up to $250,000 is tax-free. If you and your spouse have both met the two-out-of-five year residency rule, your limit is $500,000.

• Any profit you make above that amount is taxed at the capital gains rate (0 to 20%, depending on your tax bracket).

The $250,000 or $500,000 exclusion is not a one-shot deal. You can take it as many times as you like, as long as it’s on your main home and you’ve lived there at least two years out of the five before you sell.

There’s another twist. You don’t have to live in the house at the time you sell it. The two-year residency can occur anytime during the five years before you sell. So, for example, you could move out for three years, make it a rental for that period and still get the exclusion.

The sale of your vacation home, or other property that’s not your main residence, generates somewhat lesser tax breaks. You get no exclusion of up to $500,000. Your profit on the sale is taxed at the capital gains tax rate of up to 20%, assuming you’ve held the property for at least one year. If not, you’ll pay taxes at your regular, possibly higher, ordinary tax rate.
Tax Tip – Two-Out-of-Five Year Rule
Depending on why you’re moving, the IRS shows a little compassion if you sell your home before meeting the two-out-of-five year rule. Say you moved because you lost your job or had a health problem, for example, you may still be able to reduce your tax exposure on the gains. You may be entitled to a prorated portion of the regular $250,000 or $500,000 exclusion limit, depending on your case.

Cost Basis of Your Home

Basis, cost basis, tax basis, it’s all the same. Basis is basically your investment in your home (or other asset).

To figure your basis in the eyes of the IRS, first add what you paid for the house, associated fees, and the cost of any capital improvements. Then subtract items like casualty losses, and, if you used part of the house for your business, any depreciation deductions you took over the years. The result is your total investment in the house.

Your basis determines your taxable profit when you sell. Subtract your basis from the proceeds of the sale to arrive at your taxable profit. Remember that the first $250,000 for singles and $500,000 for spouses filing together are tax free.

Naturally, the larger your basis in the house, the smaller your profit will be and the lower potential taxes you’ll pay. So, when you’re calculating your basis, get out your old settlement sheets from when you first bought the home and be sure that you add to your cost of the house, things like title-insurance premiums, property-inspection fees – even utility hook-up charges. Every qualified expense hikes up your basis.
One easy rule is: anything that extends the life of your house, increases its value, or adapts it for other purposes is a capital improvement. Some examples: an addition to your home, new storm windows, finishing the basement, new heating or air-conditioning systems, even a security system would all be considered capital improvements. Repairs don’t count. Painting the house, fixing the gutters or replacing a few roof tiles are repairs and do not add to your basis.

**Tax Tip – Housing Cost Basis**

With home prices rebounding in many parts of the country, the $250,000 (for single filers) and $500,000 (for married filing jointly) exclusions from taxes when you sell your home are suddenly not as out-of-reach as they may have seemed during the recent housing slump. So keeping an eye on your cost basis in your house – saving receipts for capital improvements, for example – makes even more sense today. After all, every dollar added to your basis is one less dollar that’s vulnerable to taxes.

**Stepped-up Basis on Property**

One of the most advantageous provisions in the tax code is what’s called a step-up in basis. An asset you hold generally qualifies for a stepped-up basis if you were given the asset by someone who has died. Let’s say you inherit a house that has appreciated and you want to sell it. Your basis for the property is the fair market value of the house on the day your benefactor died.
Example
You inherit your uncle’s house, which he owned for more than one year. Its fair market value is $400,000 at the time of his death. That amount is your cost basis. If you then sell the house for $450,000, your total taxable profit is $50,000. You would pay the capital gains rate on that amount.

By contrast, if you had received the property as a gift, while your uncle was still alive, your cost basis would have been the price he originally paid for the house. Say he paid $100,000 for the home many years before. That becomes your cost basis. If you then sell the house for $450,000, your total taxable profit is $350,000.

PC Tax Tip – Leaving Your Inheritance
Leaving an inheritance rather than making an outright gift might save your heirs plenty in taxes. It’s worth discussing this tax break with a professional when planning your estate.

What happens if you sell your home at a loss? Tax-wise, the answer is nothing. You cannot deduct a loss on the sale of your primary residence. You don’t even have to report it on your tax return.

The rules for vacation homes—or any dwelling that is not your primary residence—are different. If you sell a vacation home that was intended for your personal use, you’ll need to report a loss on the sale. The IRS wants to know about the transaction (you should report it on Form 8949 and Schedule D) – even though you can’t deduct the loss.
There is one wrinkle, however. If you converted your house from personal use to a rental and you show a loss when you sell, you may be able to take a deduction on the loss but only under certain circumstances, including that the sale price has to be lower than the cost basis of the house on the day you converted it. (See more on rental property below.)

There is a way to defer your tax liability over a number of years when you sell a home or other real estate. You and your buyer agree on a down payment and on annual payments, or installments, for as many years as you wish.

Any sale that defers at least one payment until the following tax year is considered an installment sale to the IRS and must be reported using the installment method. Simply put, the payments you get as a seller are divided into two parts: the gain from the sale of your house and the return on your basis in the home.

You won’t be taxed on the return on the basis, what you originally paid for the house. But you must pay taxes on the portion of your gain in the sale each year. This is taxed at the capital gains tax rate, which is generally lower than ordinary income tax rates. Any interest you get is taxed at your regular income tax rate.

What are the benefits to the seller of an installment sale?

- Ultimately, barring any tax law changes, your total tax bill may end up being about the same as if you paid the taxes on the lump sum – you’ve delayed taxes, not avoided them.
But some sellers may not want to take as income the full gain from selling the house during the year they sell. Taking a lump sum might push them into a higher tax bracket, for example.

That’s one appeal of installment sales for wealthier sellers, especially if the lump payment pushes the seller’s adjusted gross income to more than $200,000 for singles and $250,000 for spouses who file jointly. That’s when the 3.8% net investment income tax (used to finance the Affordable Healthcare Act) kicks in. In effect the net investment income tax is a surcharge on top of your ordinary capital gains tax – pushing your taxes on gains up to 23.8%. (See Chapter 2 for more on the net investment income tax.)

Why would the buyer favor an installment sale? One upside for the buyer is that he or she gets the real estate without having to come up with bank financing for the full purchase price. But that’s a possible pitfall for the seller since he may be assuming risks that a bank generally bears in traditional home loans – such as is the buyer creditworthy? Other concerns for the seller are the buyer’s ability to make payments on time and to keep up the condition of the property.

**Tax Tip – Installment Sale Complications**

What happens if your buyer stops paying you? A cautionary note: you, the seller must deal with the complicated situation caused by foreclosure and its associated costs. There are many complex factors to consider in an installment sale so talk to an accountant or other professional before you jump in.
You don’t have to sell your rental or investment property and then buy another one – trading it for a similar property can be another tax-efficient option.

No gain or loss is realized in a like-kind transaction, so you can defer the tax liability until you ultimately sell the property. There are some basic rules for a like-kind transaction, including:

1. The property must be used only for business or investment purposes. Your main home doesn’t qualify. A rental qualifies if you’ve rented it out for 15 days or more and used it for less than 14 days, or 10% of the days the home was rented.

2. The market value of the property sold must be equal to that of the replacement property to defer all of the tax.

**Example**
You bought your building for $700,000 and it increased in value to $900,000. You can trade it for another building worth $900,000 and not pay taxes on the profit at the time of the transfer. If you traded your $900,000 building for one worth $800,000 and received $100,000 in cash, you would pay taxes on the $100,000 cash that year.

**Tax Tip – 1031 Exchange**
These so-called 1031 exchanges, named after the IRS code section, can be complicated, and must be conducted through a third party. They are best handled by consulting an accountant or real estate professional.
Here’s a common dilemma that could cost you plenty in taxes. You and your husband divorce. You buy his share and you remain in the home. Whatever amount you get in the buyout does not affect the cost basis when you’re ready to sell. You must calculate the basis using the original cost of the house, as the following example shows.

**Example**

You are divorced and you bought your husband’s share of the home. When you decide to sell, your basis in the house is what you and your husband paid for it as newlyweds – $100,000, let’s say.

Say you sell the house for $500,000. Your profit, after deducting the basis, is $400,000. You take advantage of the $250,000 (for singles) exclusion, and you now owe taxes on $150,000 in gains. This unpleasant surprise could have been handled in the divorce proceedings. For example, you could have been compensated in some other way for the tax bill that lay ahead.

Another scenario might also have been more tax-advantageous. You and your ex could have agreed to sell the house, possibly tax free, and you could have purchased another home, or in some cases – could even have bought back your family home.

**Rental Property**

You have a vacation home or a condo that you rent out. What are the tax implications of your investment?

Owning rental real estate can give you some sizeable tax benefits. It can also give you headaches as a landlord, of course,
but that’s why rental management companies exist (and you can deduct their fees).

Any profit you make on selling investment property is subject to capital gains taxes, assuming you owned the house for more than one year. In addition, your state will want its share of your gains, which could be significant depending on where you live.

The great news is that many rental expenses are tax deductible.

- As with your main house, you can generally take deductions for mortgage interest payments on loans that you used to buy your rental property and property taxes you pay. Mortgage points that you paid when you bought the property are not immediately deductible. But you may be able to amortize them, that is, claim a pro-rated deduction each year, over the life of the loan.

- Your premium payments for insuring your rental property are also tax deductible – including fire, theft, and flood insurance, and landlord liability insurance.

- Unlike with your main home, repairs on rental property are fully deductible as long as they are ordinary, necessary, and reasonable amounts. Money spent to repaint, plaster, fix broken toilets, replace broken windows, repair floors – all are deductible the year you incurred the expense.

- To recover the cost of improvements you make on the rental, however, you must depreciate the expenses over the life expectancy of your property. Putting in a new roof or adding a patio or garage, for example – are all considered improvements. (For more go to: https://www.irs.gov/publications/p527/ch01.html)
• Other deductions you can take: expenses for advertising the property for rent, cleaning, maintenance, management fees, legal and other professional fees, and the cost of utilities, if you pay the utility bills and not the tenant.

**Example**
How do you amortize the points on your mortgage loan? Say you have a 30-year fixed mortgage. Each year, you can deduct $1/30^{th}$ of the points you paid. When you sell or refinance the loan, you get to deduct all the points not yet deducted.

**Tax Tip – Don’t Deduct Vacation**
You can deduct your expenses to inspect or repair your property but be careful if it’s in a vacation spot. Be prepared to show the IRS that this was really the reason you travelled to your property, and not for a vacation.

Depreciation is key in rental properties. The depreciation deduction is intended as a tax perk to compensate you for the wear and tear on your property and to help you recover the cost of your investment. But when you sell the house, Uncle Sam wants to recover those deductions.

Here’s how depreciation deductions can affect you:

• For one thing, you might get the benefit of a tax deduction on your personal ordinary income tax rates if your modified gross income is less than $100,000.
• Depreciation deductions reduce the cost basis of your property (what you paid for it in the eyes of the IRS), which ultimately determines your gain or loss when you sell.

• You can take depreciation deductions over a 27.5-year period for a residential property rental and 39 years for an office building. If your rental property is increasing in value while you depreciate it, so much the better.

What if you have a rental income loss? You’ve added up all your deductions and when you subtract them from your gross rental income, you’re showing a loss for the year. Your next step depends on whether the IRS considers your losses passive or active.

**Passive and Active Losses**

You are automatically a passive owner unless you can prove that more than 50% of your services are devoted to the business and its rental activities.

If you qualify, your active losses on your rental are fully deductible.

On the other hand, if you have passive losses, you can only deduct them from passive income from other sources, such as a positive cash flow from other rental properties, for example.

Any passive losses after you do that calculation are deductible up to $25,000, if your modified adjusted gross income is under $100,000. Above that amount, you get a partial deduction and no deduction above $150,000.
But all is not lost. If you can’t deduct the losses in one year, they are “suspended” and you can carry them forward indefinitely. You can use those losses to offset future rental income or passive income, or you can deduct them from the profit you make when you sell the rental property.

**Sale of a Rental Property**

You’re ready to get out of being a landlord and sell your property. Here’s how you’ll be taxed:

- Your capital gains will be taxed at up to 20% (possibly 23.8% in upper tax brackets) but if you claimed depreciation, some of the profits may be taxed at the higher ordinary income tax rates.

- To figure your gains, subtract your adjusted basis in the property from your sales proceeds. The adjusted basis is what you paid for the property plus improvements and minus your depreciation deductions.

- The calculation can get complicated but the underlying fact is that the depreciation you claimed is subject to “recapture” rules. The upshot for you: some of your gain is taxed at a 25% depreciation recapture rate and some at capital gain tax rates, as the following example shows.

**Example**

You bought a rental property for $300,000. Let’s say you took $100,000 of depreciation deductions over the years you owned the property. You then sell it for $320,000. Your taxable gain is $120,000 ($320,000 - $200,000).
Here’s how your taxes break down: you pay a 25% depreciation recapture rate on the first $100,000 (amount of depreciation deductions you took) and the remaining $20,000 is taxed at a capital gains rate.

What happens if you sell at a loss? You’ve owned your rental property for more than one year and are ready to sell. You’ve figured your cost basis on the property – the original cost to you plus the cost of improvements (but not repairs and maintenance) minus depreciation deductions you took over the years.

You could have what’s called a Section 1231 loss – a confusing bit of IRS dexterity that could work in your favor:

- You can use a Section 1231 loss against any type of income you have – salary, capital gains, self-employment income and more.

- If the loss is large enough to push your other income down to nothing, you could have a net operating loss. If so, you can recover some of the taxes you paid in the two previous years by amending your tax returns.

- If you still have some left-over losses after you amend your returns for the previous two years, you can carry them forward for up to 20 years.

Note that these calculations can get complex and you may want to get professional advice.
EMPLOYEE BENEFITS
Your employer gives you a lot more than salary.

How your employee benefits are taxed can make a significant difference on your – and your family’s – financial health. And given the many and seemingly constant changes in employment and benefits laws affecting employers and workers alike, you need to pay especially close attention to the tax consequences of your benefits options before you make your choices.

This is particularly true when it comes to health care benefits. The fast-moving changes in the way health care is delivered in America – not to mention the changes in health care insurance
policies that are currently fueling a red-hot national debate – are going to affect most, if not all, American taxpayers.

This chapter looks at the tax implications of plans such as Health Savings Accounts (HSA) and Flexible Spending Arrangements (FSA). It also considers several other employee benefits – incentive stock options, non-qualified stock options and employee stock purchase plans, and offers strategies to help you choose and manage your plans. (Chapter 3 discussed employer-provided retirement plans such as 401k’s and Roth 401k’s and ways to maximize your future income in tax-sheltered ways.)

**Health Savings Accounts (HSAs)**

One of the largest benefits offered by an employer has traditionally been health care insurance. The IRS has encouraged this by allowing employers to deduct their costs from taxes. Employees, on the other hand, are generally not taxed on the benefits they receive.

But the economics of this system have been shifting dramatically, due mostly to sharply rising health care costs. (Government estimates show health care spending growing at an average rate of 5.8% from 2015 to 2025.) And employers are responding by pushing the costs of health care more and more onto – you guessed it – their employees, and that means you.

Congress – and the IRS – stepped in with somewhat of a helping hand by creating Health Savings Accounts (HSAs), and Flexible Spending Arrangements (FSAs). HSAs have been around since 2003. They offer individuals and families a way to put savings into tax-deferred accounts that they can tap for medical expenses. (Some legislators envisioned them as an eventual alternative for Medicare.) Both HSAs and FSAs (discussed
below) let you set aside pre-tax money for these purposes – alongside your traditional medical insurance plans.

Consequently, as you shoulder more of the burden of your health care it’s important to know what the tax implications are of each plan.

You contribute to an HSA directly from your paycheck, if your employer offers a plan. Or, you can open an HSA account at most financial institutions. You receive a debit card or check book that you can use to pay for eligible medical expenses, or you can file for reimbursement as you do with your medical insurance, depending on the plan.

The HSA market got off to a slow start but it’s expected to reach $50 billion in assets by 2018, up from $30 billion in 2015, according to Devenir, a health savings accounts consulting firm.

One reason to give an HSA very serious consideration is found in a recent study showing that your tax savings on your HSA could be more significant than the tax savings you realize on your 401k. The study in the Journal of Financial Planning compared the tax consequences on an employee’s contribution to an HSA with a similar contribution to a 401k. Researchers found that the HSA could outperform the 401k – and they were assuming that the employer matched the employee’s 401k contribution.

If you qualify, HSAs offer some unbeatable tax benefits:

- Contributions are made with pre-tax dollars.

- Interest and other earnings on the assets accumulate tax free.
• Distributions are tax-free if you use them for qualified medical expenses, such as prescription drugs, and payments for long-term care coverage.

• After you reach age 65, you can take out the funds, penalty free – even if you don’t use the money for qualified medical expenses. But the portion you don’t use for qualified medical expenses will be taxed.

• You don’t have to make required withdrawals after 70 ½, as you do with your traditional IRAs.

• You can take a tax deduction on contributions that you (but not your employer) make to your HSA.

• Some employers offer matching contributions.

• Unused funds can be rolled over from year to year.

• Funds in an HSA are portable. You take them with you as you move from job to job.

• You can invest your HSA assets in mutual funds, stocks and other vehicles (but not life insurance and collectibles), just as you can in an IRA, and potentially increase your investment return.

The tax consequences of HSAs are, indeed, attractive but here’s the hitch: They are available only if meet you these conditions:
• You must be enrolled in a high-deductible health insurance plan – one with a deductible of at least $1,300 for yourself-only and $2,600 for family coverage (for 2016 and 2017).

• You cannot be enrolled in Medicare.

• You have no other major health coverage aside from the high-deductible plan.

• You cannot be claimed as a dependent on someone else’s tax return.

There are also strict limits on annual contributions to an HSA: $3,350 for a single filer and $6,750 for family coverage for 2016. Contribution limits for 2017 are: $3,400 for singles, and still $6,750, for families. If you’re 55 or over you can make up a catch-up contribution of $1,000, and if both you and your spouse meet the age requirement you can each make the $1,000 contribution.

Note that the HSA limits may increase in 2018, depending on the ultimate outcome of the health care debate going on in Congress as this guide was being written in March 2016. Some members of Congress want to increase contribution limits for 2018 to $6,550 for individuals and $13,100 for families.

In addition, some HSA account holders – those who purchase health insurance from a state or federal exchange – could be caught up in the tussle in Congress over the future of the Affordable Care Act. However, anyone who has an employer-sponsored HSA need not be too worried. Many in Congress look favorably on HSAs and have said publicly that strengthening them is one of their health care goals.

There are some downsides to HSAs:
• By definition, HSA plans require higher deductibles. If you, or your family, have high medical costs in a given year, you will likely have to pay more out of pocket if you are in an HSA plan.

• The most serious downside is the penalty you face if you take money out for non-qualified medical expenses (such as cosmetic plastic surgery, hair transplants, diaper service, for example). Your entire withdrawal amount is taxed at your ordinary income tax rate.

• In addition, you will be subject to a 20% penalty fee on the amount you withdrew.

• Once you turn 65, you can withdraw funds and not face the 20% penalty but you will still be taxed on the funds unless you use them for qualified medical expenses.

• Your investment options in an HSA may not be as extensive – and possibly be more expensive--than those offered for your 401k.

• Not all employers match your contribution in an HSA, or if they do, not as generously as they do for your 401k.

**Tax Tip – Build Your HSA Before You Retire**

Once you turn age 65 and enroll in Medicare you can no longer contribute to an HSA – just as your out-of-pocket medical expenses could be increasing. So building up an HSA before you retire and then taking tax-free distributions can be a valuable strategy. Using tax-free funds to pay medical expenses in retirement helps hold down your overall tax bill at retirement
and may keep you from having to pay surcharges on Medicare premiums if you are in a high tax bracket.

**Tax Tip – Contribute to Your HSA Monthly**

If you have a high-deductible health plan – a prerequisite for opening an HSA – your premiums may be lower but you’ll pay more out of pocket if you face a medical emergency down the road. So it’s wise to build up the funds in your HSA diligently. One way to grow your HSA is to get into the habit of putting a fixed amount into your account on a monthly basis. Since HSA premiums are generally lower than those of HMOs or PPOs you could take the difference between the premium on your high-deductible plan and what your premium would have been with an HMO, for example, and put that amount into your HSA every month where it can grow tax free until you need it.

**Flexible Spending Arrangement (FSA)**

If you don’t qualify for an HSA account – say, for example, your health insurance deductible isn’t high enough to meet the threshold – and you want to set up savings account for your medical costs, your best option is a Flexible Spending Arrangement (FSA). Here are the key differences between FSAs and HSAs:

- There are no eligibility requirements with FSAs as with HSAs – anyone can take advantage of an FSA plan if your employer offers it.

- Your contributions to an FSA are with pretax dollars and any distributions you take are not taxed. It’s different for an HSA. For an HSA, your contributions are tax deductible (but can’t be taken out of your pretax pay) and your gains and distributions are tax-free.
• With an FSA, you can only change your contribution amounts during an open enrollment period or if you change jobs. With an HSA, you can change your contribution amount at any point.

• With FSAs, you “use it or lose it.” If you have an unused balance in your FSA at the end of the year, you cannot generally roll over the funds into the following year.

• FSAs are not portable unless you qualify for a COBRA extension when you change jobs. (COBRA is a federally mandated temporary extension of health benefits.) You can, however, take your HSAs with you to your next job.

Here’s a quick look at the main differences between HSAs and FSAs.

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<thead>
<tr>
<th></th>
<th>HSAs</th>
<th>FSAs</th>
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<tbody>
<tr>
<td><strong>Are you eligible?</strong></td>
<td>You must have a high-deductible health plan</td>
<td>No eligibility requirements</td>
</tr>
<tr>
<td><strong>Contribution limits</strong></td>
<td>$3,350 for individuals; $6,650 for families (2016)</td>
<td>$2,550 (2016)</td>
</tr>
<tr>
<td><strong>Adjusting contribution amounts</strong></td>
<td>You can change how much you contribute to the account at any point during the year.</td>
<td>Contribution amounts can be changed only at open enrollment or when you change jobs or your family status.</td>
</tr>
<tr>
<td><strong>Rollover allowed?</strong></td>
<td>Yes, you can rollover unused balances into the next year.</td>
<td>In most cases, you lose any unused balance.</td>
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<tr>
<td><strong>Portability</strong></td>
<td>Yes, you can take your HSA when you switch jobs.</td>
<td>In most cases, you’ll lose your FSA when you switch jobs, except if you are eligible for an extension through COBRA.</td>
</tr>
<tr>
<td><strong>Tax implications</strong></td>
<td>Contributions are tax-deductible, but they can also be taken out of your pay pretax. Growth and distributions are tax-free.</td>
<td>Contributions are pretax, and distributions are not taxed.</td>
</tr>
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**Employee Stock Purchase Plans (ESPP)**

If you work for a publicly-held company, your benefits might include an employee stock purchase plan. An employee stock purchase plan allows you to purchase shares in the company through your paycheck at a discount off the publicly-traded share price. It’s one way for your company to encourage you to participate in the firm’s success (or lack of success).

You enroll in an employee stock purchase plan during your company’s open offering period and indicate how much of your salary you want deducted from your paycheck to purchase
company stock. You don’t have to commit to buying a specific number of shares each pay period – shares are bought based on your contribution amount during the plan’s purchase period. Most plans allow you to contribute 15% of your salary or the legal maximum of $25,000.

Each plan is unique but under most stock purchase plans, the price you pay per share is discounted from the market value. You generally pay 85% of the market price when you buy shares, giving you a legal maximum of 15% discount per share.

Here are the tax implications of ESPPs. You buy into a plan with after-tax dollars and you get a discount on the share price, generally around 15%. However, when you sell company stock, you pay taxes on the discount you received at your regular income rate.

- If you hold the shares for more than one year – and more than two years after the start of your plan’s offering period (a so-called qualifying disposition) – the discount you received off the purchase price is reported as ordinary income. Any excess gain between the purchase price and the sales price is considered a long-term capital gain.

- If you hold the stock for less than one year before you sell it, and less than two years after the start of your plan’s offering period, you have a disqualifying disposition. You pay ordinary income on the “bargain” you received, that is, the difference between your purchase price and the value of the stock. Any other gains are taxed at the lower capital gains rate.
Example
You are in the 25% tax bracket. Your company stock is selling for $100 a share. You received a 15% discount and bought stock through the employee purchase plan for $85 a share. You sell immediately. Your 15% gain will be taxed at your ordinary income rate.

Example
You buy shares at a 15% discount. The stock price is $100 a share but you pay $85 a share through your ESPP. You hold onto the shares for two years and sell them for $120 a share. You pay at the ordinary income tax rate on the $15 per share (the discount) and a long-term capital gains rate on $20 per share ($120 - $100).

Tax Tip – Employee Stock Purchase Plan
It’s worth getting to know your employee stock purchase plan, complicated as it may be. ESPPs are another form of compensation. If you have the cash flow and your discount is significant (say, 10% and above) a smart strategy is to participate as much as you can and then sell right away, assuming your plan allows you to do so.

Restricted Stock Units (RSUs)
In the past decade or so, RSUs have become a popular type of compensation benefit, especially in high-tech companies. You don’t get the stock right away – you have to follow the company’s vesting plan, receiving it after a certain period of time and after meeting certain performance milestones.
Unlike in stock options, discussed below, you retain some value in the RSUs, even if the share price drops after the grant date. The downside, however, is that RSUs are taxed at the time the shares vest, not when you sell.

With RSUs when you sell, the share is assigned a fair market value and this “compensation” is considered as taxable income. Some companies give you the choice of withholding a portion of the shares to pay your income taxes. Any appreciation over the market price of the vested shares is taxed at a capital gains rate.

**Tax Tip – When to Sell Your RSU**
Since RSUs are already taxed when they vest, you should owe zero or little in additional taxes if you sell right away. Selling also helps you reduce your concentration in your company’s stock.

**Incentive Stock Options (ISOs) and Non-Qualified Options (NSOs)**

Incentive stock options are another way for a corporation to compensate and motivate their high-level employees by offering them stock options in addition to their salaries.

There is another type of stock options called nonqualified stock options (NSOs), which are discussed below. Of the two, ISOs generally get more favorable tax treatment so it’s important to know which type of options you’re getting from your employer.

First, a look at incentive stock options – how do they work? Your employer gives you the right to buy company stock at a set price (also called the exercise or strike price) within a certain time period. The appeal is that if the strike price is less than the market price when you exercise your option, you’re buying the stock at a favorable price.
You may get more favorable tax treatment on ISOs than on other types of equity compensation. Your tax liability on the stock options depends on how and when you sell the shares.

The spread between the strike price and the market price when the ISO is exercised is not subject to ordinary income tax if you meet these conditions:

- You have held the stock for more than 2 years from the day the ISO was granted and more than 1 year after you exercised the option.

- You have been working for the company granting the ISO from the date of the grant up to 3 months before the date you exercise the ISO.

The rules are complex, but here is a quick look at the tax implications of ISOs:

- You pay no regular tax when you exercise an incentive stock option.

- You report the taxable income only after you sell the stock.

- If you meet the holding periods before you sell, your gain is taxed at the capital gains rate.

- If you don’t meet the holding periods before you sell, your gain is taxed as ordinary income up to the amount by which the stock’s fair market value when you exercised your option is greater than what you paid for the stock. The rest is taxed at a capital gains rate.
• If you have a loss on the sale of stock you bought through your ISO, it’s a capital loss and you have no ordinary wage income to report.

• You do have to report the “price break” you get – the difference between the price you paid and the fair market value on the day you opted to buy the stock – as an adjustment for the Alternative Minimum Tax, which could result in AMT liability, as discussed next.

When you calculate your tax liability for AMT, which you do alongside your regular income tax (See Chapter 2 for more on AMT), you treat stock acquired by exercising an ISO as if no special tax treatment applied. That is, you first figure the amount by which the stock’s fair market value is greater than the option price and then treat that amount as an adjustment under the AMT.

**Tax Tip – The Future of the AMT?**
The AMT is a real threat when you exercise your options so factor that into your decisions. The AMT may not be around in the future – many in Congress aren’t fond of the tax, which they say is confusing. Any changes, however, aren’t likely to take effect until at least 2018, when you’ll be filing your 2017 taxes.

No tax is withheld when you exercise an incentive stock option but taxes may be due later when you sell the stock. Look at the big tax picture before exercising your options – including paying the tax liability and the sale’s possible effect on the AMT. Assess your overall capital gains and losses for AMT purposes. Note that even if you exercised your options and your stock has dropped in value, you could still be subject to the AMT.
Not all companies offer ISOs because the firm doesn’t get a tax deduction when options are exercised. For that reason, many companies, generally more mature companies, offer NSOs, non-statutory (or non-qualified) option plans, in addition to or in place of ISOs.

A company can offer NSOs to any of its employees, as well as to contractors, consultants and others. They are called non-qualified because they do not meet certain IRS requirements that allow special tax treatment.

When you sell a non-qualified stock option, you will be taxed at the ordinary income tax rate. The amount subject to these taxes is the difference between the fair market value when you sell and the price you paid for the stock, or basis. Your basis is what you paid for the stock plus any amount you included as income when you were granted or exercised the option.

Here are some key differences between ISOs and NSOs:

- Only employees can receive ISOs but anyone can receive NSOs.

- In an ISO, there is no taxable income on your regular income tax return (but possibly on your AMT, discussed below) to you when you receive the option or when you exercise it, assuming you follow the holding period regulations. In an NSO, the difference between the value of the stock when you exercise it and the exercise price is taxed as ordinary income.

- In an ISO, the difference between the value of the stock when you exercise the option and the exercise price is
considered an adjustment item when you calculate your AMT, meaning that you add that difference to your taxable income.

Gains or losses in an ISO – the difference between the amount you realized from the sale and the stock’s tax basis – may be treated as long-term capital gains or losses, if you hold the stock for the proper holding periods.
COLLEGE SAVINGS PLANS
Tax-free accounts can prepare you for looming costs.

There seems to be no end to the rising costs of higher education. If you’re a parent planning for the family’s financial future, you’ll have to factor in the costs of sending them to college – costs that have generally been rising at the rate of inflation. For 2016-2017, according to the College Board, average college costs, including tuition and room and board, are:

- $20,090 for a public in-state college
- $35,370 for a 4-year public, out-of-state college
- $45,370 for a private college
Saving early for your child’s education is one of the most important steps you can take. Here we look at two options to help you prepare for impending college costs: Coverdell savings accounts and 529 savings plans.

**Coverdell Education Savings Account**

These college savings accounts take their name from Georgia Senator Paul Coverdell, who championed them in Congress in the late 1990s. You can easily open up one at an investment firm or mutual fund company with an initial deposit ranging from about $250 to $1,000. The cap on your annual contribution is $2,000. You can also open one for each of your children, or other beneficiaries and put $2,000 a year into each until the child turns 18.

Contributions to the accounts are not deductible but your funds in the account grow tax free. You can also withdraw them tax free, as long as you use the money to pay for your child’s college expenses, including tuition, room and board, books, computer and fees. And you can make contributions up until April 18, 2017 this year, and the contribution will apply to tax year 2016.

Here’s how Coverdell accounts work:

- If you are single your contributions phase out if your adjusted gross income is between $95,000 and $110,000. If you’re married the phase-out occurs between $190,000 and $220,000 (for 2016 and 2017). If your adjusted gross income is over $110,000 and you are a single filer, or over $220,000 (married), you cannot make a contribution to a Coverdell Education Savings Account.
• Be sure the funds you withdraw go to educational expenses or your earnings will be considered taxable income and you could also get hit with a 10% penalty on the withdrawals.

• Keep an eye on your annual contribution amounts. Deposit more than the allowed $2,000 and the IRS will impose a 6% penalty for each year that the excess amount stays in the account.

• When your beneficiary turns 30 if there are still funds in the account you will have to liquidate it. A better solution to keep the tax-free account is to transfer it to a family member who is under 30 years old.

Tax Tip
A Coverdell ESA can be a good supplement to a 529 college plan, discussed next, because you can also use it to cover your child’s expenses from kindergarten through high school graduation. You can also contribute to both plans in the same year.

529 Plans
States have been offering these popular college savings accounts for a decade or so. (They get their name from Section 529 of the tax code.) They are easy to set up – online tools can help you find and compare the details of 529s in various states. The huge appeal is that your contributions to the plans grow tax free and the money you take out is tax free, as long as it’s used to fund college expenses.
You, family members or even friends can set up a 529 plan for the benefit of a future student. There are no income restrictions for either the contributor or the beneficiary to qualify for the plans and there is no limit on how many plans you can set up.

But there are limits on how much can be contributed to your beneficiary. These limits are set by the state offering the 529 plan, so they can vary. Most states allow contributions of at least $200,000 for each beneficiary. In Virginia, for example, your maximum contribution is $452,210 (2017).

As an individual, you can contribute $14,000 to each beneficiary a year without triggering gift taxes. (See Chapter 6)

However, if you contribute $70,000 (or $140,000 per couple) to a 529 plan in one year, you can treat the $70,000 (or $140,000 per couple) as having been made ratably over 5 years, so there is no taxable gift in this transfer. If your contribution exceeds this limit, the excess amount is treated as gift tax in the year the contribution is made.

**Note:** During the period in which you make the $14,000 gift to your grandchild’s 529 plan, for example, you cannot make an additional gift to the same grandchild without it being subject to annual gift tax or reducing your lifetime exclusion amount.

What happens if you withdraw from your 529 but use the money for purposes other than education expenses? You will be taxed on the amount you took out and you face a 10% penalty on the earnings. That 10% penalty might be waived under certain circumstances, such as if your child gets a scholarship at least as long as the amount you withdrew. But you’ll still pay taxes at your ordinary income rate on the money you pulled out.
You can generally leave your assets in a 529 indefinitely or cash out and pay the taxes and 10% penalty. However, since you can make a family member (a spouse, child, parents or in-laws) a beneficiary, you may want to transfer your ownership to a member who is in a lower tax bracket. That way, if they don’t use the money for education expenses, they will face a lower tax bill.

States can offer multiple plans and you can also pick from many plans from other states. Or you might go with a plan offered through a financial firm. Be sure to study the various fees – state management fees, investment fees, advisor fees – associated with the plans. One upside of going with an in-state plan that gives you a deduction on your state taxes (not all states do) is that it can help offset your fee expenses.

Here are some of the benefits of a 529 plan:

- **Tax savings.** Your 529 plan earnings – and withdrawals – are tax deferred not only on the federal level but also potentially at the state level. Plus, many states offer tax deductions, credits and other tax breaks for residents enrolled in their state plan. For example, if you live in Virginia and set up the state 529 plan, you might be able to get an annual state income deduction of up to $4,000 for each of your accounts.

- **Higher contribution limits than Coverdell ESA.** Coverdell ESA limits your annual contribution to $2,000. For 529s, many states allow sizeable sums, generally between $300,000 and $500,000.

- **Control and flexibility.** With a 529 plan, you make the investment decisions and you can plan on when to take
out the funds. More importantly, you have several options for the funds if your teenager decides not to go to college. You can change the beneficiary designation to another child or any family member, or yourself. But the funds must go to education expenses – tuition, fees, books, supplies, computers, room and board. Your beneficiary can change once a year, so if your son or daughter decides on college after all you can then convert the 529 plan back to him.

- **Limited financial aid impact.** Unlike some accounts that you set up in a child’s name, such as a custodial account, the impact of a 529 plan on your financial aid college application is minimal. Only 5.6% of the value of the 529 account is considered a parental asset for calculating your student’s eligibility for financial aid. By comparison, in a custodial account 20% of the assets are considered.

- **Strategies for funding your 529 plan.** How much of your child’s expected college costs should be funded by a 529? If your child is young, aiming to end up with 50% to 70% of your total expected costs into a 529 is a good range. This gives you a buffer from overfunding if the market performs well.

**Tax Tip – 529 Allocation**
What’s a good allocation plan for assets in your 529 plan? Your contributions to the plan have about 10 to 15 years to grow before you will need the cash for college expenses. One consideration is to look at what age-based investment options are available within the account. These investments may be heavily weighted in securities in the early years and then add more moderate bond exposure as the child ages. You may want to go with an index fund in the early years.
Tax Tip – 529 Superfund
You can “superfund” a 529 plan, that is, max out on your annual tax-free gifting over a five-year period without affecting gift taxes. For example, you and your spouse can each contribute $14,000 per year for five years for a total of $140,000 ($14,000 x 5 years x 2), as mentioned above. To superfund a 529, you simply add the money to the account and file Form 709 at tax time.

Tax Tip – 529 Eligibility
When your child graduates and there’s money left in the plan, you can make yourself the beneficiary and use the money to further your own education, maybe you want to take a tax course at your local college, or study Italian abroad. As long as the college is “eligible,” that is, it satisfies the IRS stipulation that it offers Title IV student federal aid to all students, you are free to do so.

Tax Tip – Roth Before 529
If you are eligible to contribute to a Roth IRA you should contribute to it before a 529 because you can take out the principal from your Roth IRA at any time, for any purpose. This gives you more flexibility in case your child decides not to attend college after all or if you decide you need the money for something else.

Tax Tip – IRA and 401k Before 529
You are certain your child will go to college. Which account do you fund first to save for college expenses? It makes sense to fund a 529 account after you have maxed out your traditional IRA and 401k. The tax deduction and longer deferred growth of these accounts could well outperform the tax-free growth of the 529 in a shorter period of time.
YOUR RETIREMENT

Don’t run out of money before you run out of time.

The big question when it comes to retirement planning is will your money hold out?

The signs are less than encouraging – only 39% of American workers feel “very confident” that they have saved enough for a comfortable retirement, according to the Employee Benefits Research Institute.
That percentage has been increasing in recent years, but when you consider that the average balance in a 401k was $92,500 in 2016, as reported by Fidelity Investments, and an average $93,700 in IRAs (one year in a nursing home costs around $92,000 by the way), even that 39% of very contented workers may be overly optimistic in assessing their future financial security.

Sound retirement planning starts by doing some math – preferably at least ten years before you’re thinking of retiring.

There are many sophisticated retirement tools online that can help you set your retirement goals, track your progress regularly and calculate how much you can afford to spend monthly in retirement.

A general rule of thumb is that in retirement you will need 70% to 80% of your current income to cover your usual living expenses.

Once you have a pretty good picture of your retirement finances—the income you can reasonably expect from any investments along with funds drawn from your retirement accounts and the expenses you are likely to incur, you’ll want to review it all – with an eye on the effect that taxes will have on your nest egg.

The good news for many is that you will likely be earning less taxable income in your retirement, which could help curb your tax bill. On the other hand, when you turn 70 ½ you will be required to take minimum distributions out of your IRA and 401k retirement accounts or face stiff penalties.
This chapter discusses how you might spend down your assets, while limiting your tax exposure. It also looks at estate and gift taxes and suggests moves for giving your money away – to heirs, to charity and not to taxes. This chapter should be read and consulted along with Chapter 3, which compared various tax-deferred and tax-exempt retirement accounts and their tax implications.

**Guidelines for a Better Retirement**

The ultimate goal in retirement is to cover your expenses without outliving your savings. These four rules aren’t perfect for reaching that goal but they are worth thinking about. You may decide to abide by one or another, or by your own customized version of all three.

1. **Live off your investment earnings.** One suggested rule of thumb is to leave your principal in your retirement accounts untouched and live off earnings – such as interest and dividends. Critics of this rule say that while it makes sense to conserve your principal, focusing on high return rates may tempt a retiree to switch to high-dividend stock, for example, instead of maintaining a diversified portfolio.

2. **The 4% rule.** This easy-to-understand concept calls for withdrawing 4% of your entire nest egg – the value of all your retirement assets – the first year and continuing to withdraw that amount, adjusted for inflation each subsequent year. The rule is the brainchild of financial planner William Bengen, who more than two decades ago tested a variety of withdrawal rates and hit on 4% as the optimal number to sustain your funds for 30 years. One criticism of the Bengen Rule is its lack of flexibility for retirees who want to spend more in their early retirement.
years and lower amounts in later years. Others point out that even a 5% or 6% withdrawal rate can be sustainable for most retirees, if you maintain a balanced portfolio. They add that you can always lower your spending rate in your later years if you find your assets diminishing at an uncomfortable rate. But, as a rough guideline, drawing down your assets at a rate of 4% per year is a reasonable goal – assuming you are not able to conserve the principal.

3. **Let the IRS’ required minimum distributions on withdrawals be your guide.** Most people regard the IRS with disdain or suspicion, certainly not a friend. But, according to a recent study, the IRS may be offering you if not a helping hand, a helpful guidepost. A study by the Center for Retirement Research at Boston College in 2012 found that the IRS may have hit on a winning formula for sustaining your retirement income – the required minimum distributions (RMDs) that you must start taking from your IRAs and 401k’s when you turn 70 ½ (discussed below). The researchers found that given a typical retiree’s asset allocation, the IRS’ required minimum distribution schedule performs very well. It was as effective as #1, above, and more so than the 4% rule, #2 above. But this guideline isn’t perfect either – the required withdrawals could be too low in the early years after minimum withdrawals are required when you’re younger and hopefully more active and may want to spend more.

**Tax Tip – Time Horizon**

In the end, a successful retirement plan requires flexibility. If you have a shorter time horizon (less than 25 years) you may be able to have higher withdrawal rates. The goal is to customize a
plan that’s comfortable for you and revise it as life inevitably throws a few curveballs.

**Required Minimum Distributions (RMDs)**

Starting in the year you turn 70 ½ you are required to take out a minimum portion of your accumulated funds in tax-deferred accounts, such as an IRA or 401k each year. The withdrawals you take from your IRA and 401k are generally taxed at your ordinary income tax rate, not the lesser capital gain rate. If you do not withdraw the required amount, you are subject to a penalty. Note: Roth IRAs are an exception – since the funds contributed were after-tax dollars, withdrawals are tax-free, and there are no annual minimum required distributions. (See below for details.)

Baby boomers – those Americans who are now between 53 and 70 years ago – are the first generation of retirees who have to cope with IRAs, 401k’s and required minimum distributions. Many older retirees still benefit from company pensions, which pay a fixed amount each year, usually based on your salary at the time you retire. So, we don’t really know yet how this social experiment in individually managed retirement plans – that were first created by Congress in the 1970s – will work out. Will individuals have managed their retirement accounts well and saved enough – or not? Over the next few decades, we’ll find out.

Which retirement accounts are subject to required minimum distributions after you turn 70½? The rules apply to all employer sponsored retirement plans:

- Profit-sharing plans
• 401k, 403b, and 457b plans
• Traditional IRAs
• IRA-based plans such as SEPs, and SIMPLE IRAs (See Chapter 3)

The rules do not apply to a Roth IRA if you have held it for at least five years and are at least 59 ½. Because you contributed to the Roth in after-tax dollars you can withdraw your contributions anytime, tax free and penalty free.

Roth 401ks are subject to required minimum withdrawals if the plan remains in your company after you no longer work there. One solution is to rollover the funds into a Roth IRA and not worry about minimum distributions.

How are distributions taxed?

• The amounts you withdraw count as taxable income, except for IRA contributions you made that were nondeductible.

• If you do not make a withdrawal at age 70 ½, or the amount you make does not meet the minimum, you face a 50% tax on the shortfall.

• You cannot avoid taxes on a required minimum distribution by rolling it over to another tax-advantaged account.

• You can take out more than the minimum amount or you can close out your account. But you can’t apply excess withdrawals in one year toward the required minimum distributions for a future year.
Example
Your RMD for 2016 was $5,000 but you did not make the withdrawal. Your penalty is $2,500. If you took out only $2,000, your penalty is $1,500 or 50% of the shortfall.

Tax Tip — Don’t Withdraw Less
If you face a 50% tax penalty for not withdrawing or not taking out enough and you are over 70½, all is not lost – if you act quickly. The IRS may forgive the penalty if you make the proper withdrawal right away and file IRS Form 5329, attaching a short statement to explain your oversight.

Calculating your RMDs requires a bit of work on your part, especially if you have multiple retirement accounts. There are two key factors: your age and your life expectancy.

- Start with the fair market value of your IRA as of December 31 of the previous year. You’ll need to calculate your RMD separately for each IRA you own but you can withdraw the total RMD for the year from any of the IRA accounts you own and in any combination you prefer. However, that does not include your RMDs from other types of retirement plans, such as 401k’s.

- Divide the balance of your account by your life expectancy, according to the IRS life expectancy tables found at: https://www.irs.gov/publications/p590b/index.html#en_US_2016_publink1000231236 Then use the IRS worksheet to calculate your RMD.
If you have more than one IRA, total the required minimum distributions for all the accounts. This is the minimum you must withdraw for that year.

If all this has you scratching your head, just go to an online RMD calculator to estimate your required annual distributions.

The example and chart below give you an idea of what your estimated RMDs would be on a $1 million IRA.

Example
You turned 70 years old, and as of last December 31, you had $1 million in your IRA. Assuming a 5.5% annual growth rate, your first minimum required withdrawal will be about $36,496. When you are in your mid-90s, the annual withdrawal will peak at about $92,765. Note that this calculation does not account for inflation, which can reduce your real income.
When do you take the first RMD? You have to take your first RMD no later than April 1 of the year after the calendar year you turn 70½. After that, you have to take RMDs by December 31 of each year.

Example
What happens if you turn 70½ mid-year, say on July 15, 2015. You must take your first RMD for tax year 2015 by April 1, 2016. Your second one is due by December 31, 2016 (for 2016), and your third by December 2017, and so on for future years. Note that in 2016 you would be taking two distributions in one year. To avoid double RMDs in one year, the IRS allows you to take your first withdrawal by December 31 of the year you turn 70½ rather than waiting until April 1 of the following year.

You have two options if you inherit an IRA from your spouse: roll it over into your own IRA or remain a beneficiary.

- If you rollover the IRA, as most spouses do, you start your required minimum distributions when you turn 70½.

- If you remain a beneficiary, you start taking RMDs when your spouse or whoever left you the IRA would have turned 70½. You figure your own life expectancy to calculate the required minimum distributions each year.

- If you don’t make the minimum withdrawals you will generally be liable for a 50% penalty tax on the difference between the RMD and the amount you withdrew.

- You are free to withdraw more than the required minimums or close out the fund. But whatever funds you receive will generally be taxed at the ordinary income rate.
If you inherit an IRA from anyone other than your spouse, other rules apply, such as the following. Your RMDs start the year after the original owner dies and you are taxed on the distributions. You use your own life expectancy to calculate your RMDs. All the assets must be distributed by December 31 of the fifth year in which your donor died.

**Tax Consequences of RMDs**

Don’t be caught off guard when you turn 70 ½ and are faced with sizeable taxable income from your required minimum distributions.

The key to limiting your tax exposure is to determine whether you will be in a higher or lower tax bracket in your retirement. There’s no way to calculate your future tax bracket precisely, of course, especially with unforeseeable changes in tax laws. But you should be able to gauge the general direction. You can’t avoid taxes in retirement but you can try to control them. Here are some strategies to consider to lower your taxes on RMDs:

1. **Withdraw at age 59½.** You can start withdrawing funds from your traditional IRA or 401k once you reach age 59 ½, without being subject to the 10% early withdrawal penalty. Your money, however, will still be taxed at ordinary income rates. These withdrawals over time may reduce the balance subject to RMDs or at least possibly not increase it by the time you’re 70 ½. Of course, at 59 ½ you may still be working and have a higher income than you will when you reach age 70 ½. So before you start taking distributions at age 59 ½, be sure that the additional income you withdraw doesn’t push you into a higher tax bracket. Also, any withdrawal you make, of course, reduces the amount of funds in your IRA or 401k—as well as the tax-free
earnings on those funds while they are still in your retirement account, so that’s yet another factor to consider.

2. **Consider a QLAC.** A “qualifying longevity annuity contract,” or QLAC is an IRS approved deferred annuity that pays out only when your turn 85. You can use 25% of your IRA or $125,000, whichever is less, to fund the annuity. That dollar amount is excluded from your required minimum withdrawals. QLACs can be a good way to help ensure that you don’t outlive your savings – but you are also assuming that you will live beyond 85.

3. **Consider a Roth IRA conversion.** Converting your traditional IRA into a Roth IRA can help lower your RMDs. The trade-off is that the assets you convert are taxed at your higher ordinary income rate. But depending on your circumstances the strategy may be worth it. Say you are a new retiree and your taxable income has fallen, putting you in a lower tax bracket. You may want to convert your assets into a Roth incrementally over the years leading up to the year you turn 70 ½. That way you minimize the effects of the taxes you pay to make the conversion. At the same time, you are lowering your RMD base.

4. **Donate appreciated assets.** You can donate up to $100,000 a year in appreciated assets from your traditional IRA (but not 401k assets) directly to an IRS qualified charity. The charitable transfer has to be done through the IRA trustee and is not taxed. It is not valid, however, until the year you actually turn 70½.

Or, you can donate through a donor advised fund, easily opened through a brokerage firm or mutual fund company for as little as
$5,000. You pool your money in the fund and it grows tax-free while you decide which IRS qualified charity will get your donation. You can give cash, stock, mutual funds or other assets. By transferring rather than selling appreciated shares, for example, you avoid paying capital gains and can take a long-term deduction for the full amount you donate to a donor advised fund. Plus, you reduce the base for your eventual minimum required distributions.

**Tax Tip – Donate Appreciated Securities**
Consider this strategy. The same year that you convert your IRA assets to a Roth IRA, donate appreciated long-term securities from your taxable account to charity. The taxes you pay for the conversion could be offset by the deduction you get from your donation.

Which accounts should you withdraw from in retirement? You’re retired and using your RMDs from your IRAs, Social Security payments, and any pension or annuity payments for your living expenses. Which accounts do you turn to next in the spending down process? Here’s a look at the tax implications of withdrawing from your taxable accounts and your Roth accounts.

1. **Taxable accounts.** Start by withdrawing income – dividends and interest – produced in these accounts. You pay the capital gains tax rate on this income, which is generally lower than the ordinary tax rate applied to funds taken out of traditional IRAs and 401k’s. In addition, your retirement account assets can continue to grow tax-deferred.
2. **Roth IRAs and Roth 401k’s.** Roth assets should generally be held in reserve rather than tapped regularly. They have no required minimum distributions and are tax-free, making them extremely tax efficient. But in some cases, it may make sense to withdraw funds. Say you’ve taken out just enough from your traditional IRA that you don’t get bumped up to the next tax bracket, and you expect to be in a lower tax bracket in the future. Then if you need more funds, you could turn to your tax-free Roth.

**Gift and Estate Taxes**

The tax rules and regulations on estate and gift taxes are among the more complex that the IRS has to offer – and that’s saying a lot. Both the estate tax and the gift tax are taxes on the transfer of property from one person to another, either at death or while the donor is still living.

Any individual can give up to $14,000 (in 2016) to any number of family and friends without incurring gift tax. A married couple filing a joint return can give double that amount – $28,000 (in 2016) – to any number of family and friends each year. The gift tax exclusion amount has been stuck at $14,000 since 2014 and will remain at that amount for 2017.

**Example 1**

Your daughter got married in 2016 and you and your spouse would like to give her and her new husband a gift to help them start their lives together. You and your spouse can give $28,000 to your daughter in 2016 without incurring any gift tax. You can also give your daughter’s new husband, $28,000 in 2016 without incurring any gift tax.
In succeeding years, should you wish, you can give your daughter and son-in-law similar amounts up to the annual gift tax exclusion amount for that year without paying any tax.

**Example 2**
You have a new grandchild born in 2016. You can gift him or her up to $14,000 (2016) and similar amounts (up to the annual gift exclusion amount) in each succeeding year without incurring any gift tax.

**Note:** In Examples 1 and 2 above, annual gifts that are equal to or less than the annual gift exclusion amount *do not count* in figuring lifetime gifts for estate tax purposes.

The estate tax takes effect at such lofty levels that it applies to only to the wealthiest of taxpayers – and if many in Congress have their way, the estate tax might not be around for long.

In the meantime, though, only estates worth more than $5.45 million in 2016 ($5.49 million in 2017) are liable for estate taxes. For married couples that exclusion doubles to $10.9 million. A 40% tax rate applies on any excess over the exemption amount.

The $10.9 million exclusion from federal taxes (state taxes may apply) isn’t automatic, however. Under the so-called “portability” rule, a surviving spouse can use a deceased spouse’s unused estate tax exclusion.

So if the deceased spouse had not fully used the estate tax exclusion, the unused portion, technically called the “Deceased Spousal Unused Exclusion Amount” or DSUE, can be transferred to the surviving spouse. The surviving spouse’s total
exclusion becomes the sum of his or her exclusion and the DSUE amount.

**Example**
You are married and your wife dies. Your wife’s estate is worth $3 million and yours is worth $7.5 million. She funded a family trust with her $3 million. Your DSUE amount is $2.45 million (her $5.45 million exclusion in 2016, minus the $3 million shielded in the family trust). Your exclusion is $7.9 million (your own $5.45 million exclusion plus the $2.45 million DSUE amount).

To take advantage of the “portability” rule, an estate tax return must be filed when the first spouse dies – even if no tax will be due. Because portability has many requirements and restrictions, it’s best to seek the advice of an estate attorney.

**Tax Tip – Your Beneficiaries**
Beneficiaries you designate in your retirement accounts supersede wills, trusts or probate. So, do a periodical check of who your designated beneficiaries are on your retirement accounts, to be sure you’re not leaving them to someone you no longer intend to receive them.

The key difference between estate and gift taxes is that estate taxes are paid by heirs and gift taxes are paid by the donors.

Gift taxes and estate taxes are connected in that gifts – over and above those gifts that qualify for your annual gift exclusion (see above) – you make during your lifetime will reduce the amount
of your taxable estate. Federal taxes on gifts and estates don’t kick in until you’ve given away more than $5.49 million in 2017. And if you’re married, your spouse can also make gifts of the same amount, pushing up the amount to $10.9 million. So, in addition to gifts that qualify for the annual gift tax exclusion, you and your spouse can give away to your heirs $10.9 million—either while you are still alive or in your estate—tax-free.

Once you pass that marker—and it is subject to change by an act of Congress—you are taxed on the excess at a 40% rate. But even before you reach that marker, the IRS requires you to report any gift that’s more than the annual limit. The excess—anything more than $14,000 in 2016—counts toward your lifetime exclusion.

**Example**

In addition to making a gift of $14,000 that qualifies for the annual gift tax exclusion, you give a gift to your new grandchild of $1 million in 2016, the year she was born. The $1 million gift needs to be reported to the IRS on your 2016 tax returns and it will reduce your unified exclusion amount by $1 million—from $5.49 million $4.49 million. Note that the $4.49 million will still be able to grow with inflation.

Current exemption amounts are so high that 98% of Americans will not owe federal taxes on their estates. But for the small percentage that might, here are some moves to consider.

1. **Use your gift-tax exemption.** Give up to $14,000 a year ($28,000 for spouses who “split” gifts) to any number of family members and friends without incurring a gift tax. Any amount over the annual limit is applied against your lifetime exemption. The gifts will reduce your taxable
estate. But gifts above the annual exclusion also reduce your lifetime tax exemption.

**Example.**
Say you want to give four people $25,000 each this year. That is $11,000 per person above the $14,000 annual exclusion. In this case, that would be $44,000 accumulated toward your lifetime exclusion that would have to be reported. To do so, file a gift tax return (IRS Form 709).

2. **Set up custodial accounts for gifts to minor children.** Custodial accounts are a great way to pass money on to your children who are minors. You can make annual gifts up to the $14,000 limit for 2017 ($28,000 for married couple). The gifts are tax free and you can manage the account as you wish. Depending on your state’s laws, when the child reaches a certain age (18 to 25), the account must be transferred to the child.

3. **Set up a college fund with a tax-free gift.** These so-called 529 college savings plans are your gifts to your future college students. You can make a lump sum contribution of up to $70,000 (2016), or five times the $14,000 tax-exempt limit for your child and your spouse can match that amount. You can then treat the gift as if it were made in equal payments over the five years (2016 to 2020). You incur no gift tax and the payments do not reduce your estate or gift tax exemptions. Any gifts above the $70,000, however, will count against your $5.45 million exemption ($5.49 million in 2017). (For more on 529 plans see Chapter 8.)
4. **Make charitable donations.** Giving money to charity is nearly always a good idea to remove assets from your taxable estate and get an immediate tax deduction. Whether you set up a private foundation, a charitable remainder trust or give directly to a qualified charity, your donations are deductible at a rate commensurate with your peak marginal rate. So, if you’re in the 25% marginal tax bracket that’s a deduction of $.25 for every $1 donated.

**Tax Tip – State Estate Taxes**
Note that 18 states and Washington D.C. have separate estate or inheritance taxes (in some cases both) and their exclusions are generally lower than federal limits. Some can be burdensome, sometimes kicking in for estates valued at $1.5 million or less. Your home, retirement accounts and sometimes life insurance could be included when your estate is valued for tax purposes. The picture is changing though – to retain wealthy retirees many states have been easing up on estate taxes in recent years.

**Tax Tip – Appreciated Stock**
Hold on to your appreciated stock if you don’t need the money and aren’t planning on donating the shares. If you give them as gifts, your recipient could face potentially hefty capital gains taxes when he or she sells them. Instead, if you pass the assets on to your heirs in your estate, they benefit from using a *stepped-up basis* for calculating taxes on the stock. In effect, when they sell they are not paying for gains incurred from the day you purchased them, only from the day of your death, significantly reducing their tax bill.
TAX LAW CHANGES
What will Washington send our way?

Congress is expected to make its mark on the tax code this year and it could be significant. It’s too soon to tell which of several proposals will become law, but any changes that are enacted will most likely not take effect until 2018 as you calculate your 2017 taxes.

Here’s a summary of some key tax provisions that may be on the table when Congress focuses on taxes – along with some tips at the end for coping with the uncertainty.

- **Tax brackets.** The current seven tax brackets may shrink to three: 12%, 25% and 33%. Those now in the 39.6% tax bracket (above $500,000 in income) would be in the 33% bracket – a saving of $66 for every $1,000. Depending on which plan wins, changes in the top marginal rates could
kick up the tax rate for some taxpayers – for example, single taxpayers now in the 28% bracket ($125,000 to $450,000) could face a higher rate. Another plan would simply lower the top rate to 25%.

- **The standard deduction.** There’s some give and some take in the proposed plans. The give would nearly double the standard deduction. The take is that personal exemptions – the $4,050 taxpayers below a certain income can deduct for each family member – might no longer be allowed.

- **Itemized deductions.** It looks like many itemized deductions could be on the chopping block. But some popular ones, like the mortgage interest and charitable contributions deductions, may be spared.

- **Capital gains rate.** Two plans are up for discussion – one would lower the top threshold where the 20% rate kicks in, meaning taxpayers now at the 15% rate could be pushed up to the 20% rate. Another plan would effectively drop the top rate to 16.5%.

- **The AMT and the 3.8% surtax.** There seems to be widespread support for eliminating the alternative minimum tax, either directly or by lowering tax brackets and cutting allowable deductions, causing it to die on its own. The 3.8% surtax on investment income, which helps fund the Affordable Care Act, is responsible for hiking up the capital gains rate – from 20% to 23.8% – for some high-income taxpayers. Its fate – tied in with the health care debate – is unclear.

What’s an investor to make of all this?
• On capital gains, if you’re taxed at the 15% rate as most taxpayers are, the proposed changes in capital gains taxes aren’t likely to have a significant impact. But if you’re now in the 0% bracket -- which could disappear – you may want to take a second look at your appreciated assets.

• Taxpayers facing the 3.8% surtax may want to consider deferring realized gains until 2017 or 2018, depending on if and when the tax is eliminated. But first weigh the importance of diversification in your portfolio, which could override the tax consideration.

Some strategies nearly always make good investment sense:

• Maximize your retirement savings by funding your IRA and 401k and sheltering your gains from taxes – you want to defer taxes to the future, and if rates come down you could be in a lower tax bracket when you take out your funds.

• Harvest your losses. A net $3,000 loss is potentially worth $1,200 less in federal taxes.

• Take another look at converting to a Roth IRA. Converting a traditional IRA into a Roth, in which you pay taxes now but can later withdraw funds tax free, can make great sense. If you could benefit from a conversion (see Chapter 3), plan the conversion in stages so you don’t get pushed into a higher bracket. If rates come down in 2017 you could undo the Roth and convert later.