Tax strategies for higher-income taxpayers

This overview summarizes some of the key areas that you and your tax advisor should assess. Your Financial Advisor can assist in evaluating investment decisions that could help mitigate your tax liability.

Together we'll go far

Understanding how key tax laws may affect you

▶ Medicare surtaxes on compensation and/or net investment income

The 2010 health care reform act included two key tax provisions that affect higher-income taxpayers:

- A 0.9% Medicare surtax on compensation (including net self-employment income) above $200,000 (individual filers) or $250,000 (married/joint filers)
- A 3.8% Medicare surtax on the lesser of net investment income or the excess of your modified adjusted gross income (MAGI) over those same thresholds

For more details on these Medicare surtaxes, ask your Financial Advisor for a copy of our report, "Medicare Taxes for Higher-Income Taxpayers."

▶ Reductions to itemized deductions and phase-out of personal exemption

For taxpayers with adjusted gross income (AGI) over $258,250 (single filers) or $309,900 (married/joint filers), the following phase-outs apply:

- Itemized deductions will be trimmed by 3% of the amount by which your AGI exceeds these thresholds. However, the amount of your itemized deductions will never be reduced by more than 80%.
- The personal exemption amount will be trimmed by 2% for each $2,500 (or portion thereof) by which your AGI exceeds the thresholds.

▶ Higher income, capital gains and qualified dividend tax rates

For those with taxable income greater than $413,200 (single filers) or $464,850 (married/joint filers):

- Ordinary taxable income above those thresholds will be taxed at a 39.6% rate.
- Long-term capital gains above the thresholds will be subject to a 20% tax rate. If you are in this tax bracket, you must also add in the 3.8% Medicare surtax on capital gains (discussed above), resulting in a possible combined rate of 23.8%.
- Qualified dividends above the thresholds will be taxed at a 20% rate along with the 3.8% Medicare surtax, resulting in a possible 23.8% marginal rate.

▶ Alternative minimum tax (AMT)

The exemption amounts used to calculate a taxpayer's 2015 AMT income are $83,400 for married/joint filers and $53,600 for single filers.

(The AMT calculation is separate from the regular taxable income calculation and requires you to add back certain tax deductions and income exclusions to your regular income tax to arrive at your alternative minimum taxable income. For more details on the AMT, ask your Financial Advisor for a copy of our report, "AMT and the Individual Investor.")

Strategies to consider in the current tax environment

The American Taxpayer Relief Act of 2012 increased taxes for most higher-income taxpayers. Stay focused on your long-term objectives, and meet with your Financial Advisor to develop and manage an asset allocation strategy that will help you work toward your goals. As you consider adjustments based on tax considerations, keep an eye on how much money you will keep versus what you will pay in taxes.

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For example, even at the highest possible combined long-term capital gain and Medicare surtax rate of 23.8%, you retain all of your cost basis value from a transaction plus 76.2% of your gain. Long-term capital gains rates may be higher than in previous years, but 23.8% is still less than the 43.4% rate on ordinary income (39.6% income tax plus the 3.8% Medicare surtax). If you and your Financial Advisor determine that repositioning some of your portfolio will better help you achieve your goals, tax considerations should not hold you back.

It may be challenging to keep your income below the thresholds. Some other common tax planning considerations include timing of income and deductions as well as understanding the character of the income you receive. You may have such questions as:

- How do the phase-outs of itemized deductions and personal exemptions work?
- Should you defer compensation?
- Should you choose investments that offer tax deferral?
- Can you change the tax character of income you receive?
- How may the timing of gain recognition affect your tax bill?
- Are you subject to alternative minimum tax (AMT)?

In the remainder of this report, we'll address these questions, providing you and your team of advisors – tax, legal, and financial – both the advantages and limitations of various strategies.

How do the phase-outs of itemized deductions and personal exemptions work?

You'll want to work closely with your tax advisor to project how these rules may affect your tax liability.

Here are several simplified examples to help you understand these new phase-outs; realize that your tax advisor will do a more formal calculation of the "haircut" amount. It's also important to understand that these phase-outs are caused by your income level, not by the deductions you take.

Itemized deduction examples

Itemized deductions subject to the phase-out include state and local taxes, mortgage interest, charitable deductions and miscellaneous itemized deductions. This phase-out does not reduce deductions for medical expenses, investment interest expense or casualty losses. These simplified illustrations give you an idea of what you might expect in various scenarios.

Example 1. Assume that you are an unmarried individual, your AGI is $325,000 and the sum of your itemized deductions on Schedule A subject to phase-out is $50,000. Your AGI is $66,750 above the threshold for a single filer ($258,250). Three percent of $66,750 is $2,002.50. You would subtract $2,002.50 from your $50,000 itemized deductions and deduct only $47,997.50.

Example 2. Assume you are a married couple filing jointly and your AGI is $3 million because you sell your business in 2015. Your itemized deductions subject to phase-out total $80,000. Your AGI is $2,690,100 over the $309,900 threshold for a married couple filing jointly, so you calculate 3% of $2,690,100, or $80,703. Even though the reduction is higher than your itemized deductions, you may still deduct $16,000 (20% x $80,000). Your itemized deductions are never reduced by more than 80%.

Personal exemption examples

The phase-out of the personal exemption deduction works similarly, but there is no 80% limit. That is, it is possible that your personal exemption amount could be reduced to zero. The exemption is reduced 2% for each $2,500 of income over the threshold. So if your income is $125,000 or more over the threshold (50 x $2,500), the reduction is 100%. The following examples are again simplified but give you an idea of what you may expect in different scenarios.

Example 1. A married couple with no children has a $450,000 AGI. The 2015 personal exemption amount is $4,000, and each spouse can claim an exemption for a total of $8,000. However, the couple's AGI exceeds the $309,900 threshold by $140,100. The exemption will be trimmed by 2% for every $2,500 over the threshold, which exceeds 100% in this case ($140,100 ÷ $2,500 x 2% = 112%). As a result, the couple has no personal exemption deduction.

Example 2. A single person with no children has AGI of $308,250 and one personal exemption valued at $4,000. Because this person's AGI exceeds the $258,250 threshold by $50,000, his or her personal exemption deduction will be trimmed by $1,600 ($50,000 ÷ $2,500 x 2% x $4,000) to $2,400 (rather than the full $4,000).

You'll want to work closely with your tax advisor to project how these rules may affect your tax liability. You may find that these anticipated phase-outs will require adjusting your withholding amount throughout the year or making estimated tax payments to avoid underpayment penalties.

Should you defer compensation?

Whether you should defer income depends on your individual situation, what goals you're attempting to accomplish, your need for current income and your employer's (or business's) flexibility. As always, taxes should be only one of many factors you weigh as you make your financial and investment decisions. However, deferring receipt of taxable income can help reduce your current exposure to the:

- Highest (39.6%) tax bracket, which starts with taxable income of $413,200 (single) or $464,850 (married filing jointly)
- 20% long-term capital gain and qualified dividend rate for those in the 39.6% tax bracket
- 3.8% Medicare surtax on the lesser of net investment income or the excess of MAGI over $200,000 (single) or $250,000 (married filing jointly)

As mentioned earlier regarding long-term capital gains, keep your eye toward a balanced approach and actions that may be in your best interest. For any decision you consider that enables you to defer income, you'll need to determine whether the tax savings is more important than the benefits of receiving and enjoying a higher income (whether in wages or investment returns).

Some strategies that may allow you to defer compensation include:

Technique	Benefits	Considerations
Maximize contributions to tax-deferred retirement savings [IRA, 401(k), SEP, etc.]	• Boosts your retirement savings and improves the chances of retirement security • Reduces current taxable income and AGI (does not apply to Roth vehicles) • Earnings received in accounts are tax-deferred	• Reduces your net take-home pay • If contributed to **non**-Roth accounts, could increase taxable required minimum distribution (RMD) amounts in the future • Does not avoid the 0.9% Medicare surtax
Enroll or increase contributions to a nonqualified deferred compensation plan (if available from employer)	• Boosts savings that could be available in the future, perhaps post-retirement (depending on plan features) • Reduces current taxable income and AGI	• Lowers current spendable cash • Does not avoid 0.9% Medicare surtax • Assets are "at risk" to employer's creditors • No current access to savings, and ability to control timing of distributions is highly restricted • May increase taxable income in future years as distributions are taken/required; future tax rates are uncertain
Manage the timing of employer granted stock option exercises	• Allows for possibility of realizing income in a future year when total income may be lower • Exercising in-the-money options provides additional assets or cash flow • Allows asset growth with no capital outlay	• If you retain the company stock following exercise, you may increase risk of overconcentration in your portfolio • Exercising options has tax consequences; it may increase your AMT exposure or your exposure to the 0.9% Medicare surtax on compensation • A successful stock option exercise strategy likely requires the assistance of both your tax advisor and Financial Advisor

Should you choose investments that offer tax deferral?

Certain investments that offer tax deferral involve more complexity — understand the implications of owning.

Whether you're concerned about higher income tax brackets or the Medicare surtax, investing in certain assets that are tax-deferred can reduce your taxable income from investments and lower your current year tax liability. Tax-deferred is not the same as tax-exempt; that is, at some point in the future, tax-deferred investments will have some type of tax consequence associated with a sale or distribution of the assets. That's why you'll want to work closely with your tax advisor to project how withdrawals or sales of these assets may affect your future income tax liability.

You'll also want to involve your Financial Advisor. Certain investments that offer tax deferral involve more complexity – whether in recordkeeping or regulatory procedures. You'll want to understand the implications of owning these assets and any additional reporting that may be necessary or accompany this ownership.

Some of the tax-deferred investments you can consider include:

Technique	Benefits	Considerations
Invest in a tax-deferred annuity	• Income earned within tax-deferred investments is not included in the calculation of these taxes until distributed • Potential to accumulate more for retirement • Tax free reallocations among investment options	• Annuities can be complex investments • Withdrawals prior to age 59 ½ may be subject to a penalty • Contracts may impose surrender charges for early withdrawals • Nonqualified annuity distributions may be subject to the 3.8% Medicare surtax • Gains do not avoid taxation upon your death; subject to tax upon withdrawal
Master limited partnerships (MLPs)	• In general, cash flow from MLPs is partly taxed as ordinary income and partly deferred	• Tax-deferred portion is taxed as ordinary income at the time of sale • More complex than regular stocks and typically involve more complex tax reporting
529 college savings plan	• Income earned is not included in calculation of federal income tax or Medicare surtax if not distributed • Distribution of earnings may be federal-income-tax-free if used to pay qualified education expenses	• To achieve tax benefits, use of funds is limited to qualified education expenses • Investment choices are generally limited and may only be changed once per tax year or when there is a change of beneficiary • Nonqualified withdrawals subject to tax and penalties

The investments discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Taxes are only one of many factors that should be taken into consideration when choosing an investment.

Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns.

Deferred variable annuities are long-term investments suitable for retirement funding and are subject to market fluctuations and investment risk. Withdrawals of earnings are subject to ordinary income tax. In addition, a federal 10% penalty may apply to withdrawals taken prior to age 59½, and surrender charges generally apply.

Master limited partnerships (MLPs) are not appropriate for all investors and are particularly not usually appropriate for retirement-related accounts. Also, an MLP shareholder, i.e., a limited partner unit holder, receives a K-1 instead of a 1099. Investors should contact their tax accountant for further tax implications before investing in MLPs.

Please consider the investment objectives, risks, charges and expenses carefully before investing in a 529 savings plan. The official statement, which contains this and other information, can be obtained by calling your Financial Advisor. Read it carefully before you invest. The availability of such tax or other benefits may be conditioned on meeting certain requirements. 529 plans are subject to enrollment, maintenance, administrative and management fees, and expenses. Nonqualified withdrawals are subject to federal and state income tax and a 10% penalty.

Technique	Benefits	Considerations
Tax-managed mutual funds or ETFs	• Generally designed to have lower turnover of underlying assets than actively managed mutual funds, resulting in lower capital gain distributions to unit holders	• Tax efficiency does not guarantee better performance • Investment will fluctuate and may be worth more or less when redeemed
Life insurance	• Earnings accumulate tax-deferred • Tax-free withdrawals can be taken up to the amount of premiums paid; loans can be used for earnings portion to keep tax-free; some exceptions apply • Transfer at death income-tax-free	• Could pay mortality and operational costs for death benefit you do not need • Withdrawals above premiums paid are taxed as ordinary income • If policy becomes a Modified Endowment Contract (MEC), all earnings come out first for withdrawals or loans and are fully taxable • Loans against policy reduce death benefits; if too large, policy may lapse

Mutual fund investing involves risk. The investment return and principal value of your investment will fluctuate, and your shares, when redeemed, may be worth more or less than their original cost.

Exchange traded funds are subject to risks similar to those of stocks. Investment returns may fluctuate and are subject to market volatility so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost.

Can you change the tax character of income you receive?

Evaluating certain changes to your portfolio may allow you to adjust the way your investment returns are taxed. But these changes may also alter your asset allocation as you consider rebalancing certain asset classes. You'll want to discuss any changes with your Financial Advisor to help ensure your repositioned asset allocation has you on track toward your investment objectives. You don't want to derail a long-term plan to avoid a short-term tax liability.

If you're concerned, for example, about the 3.8% Medicare surtax on net investment income, you might think about investing in tax-exempt municipal bonds or consider moving investments that generate taxable income to retirement accounts.

Net investment income includes:

- Taxable interest
- Dividends
- Net capital gains
- Taxable nonqualified annuity distributions
- Rents and royalties received as passive income
- Passive income from partnership interests, including MLPs

Net investment does not include:

- Tax-exempt interest
- Distributions from IRAs and employer retirement plans
- Income from an active trade or business
- Veteran and Social Security benefits

In addition, by changing the tax character of some of your investment income, you may also reduce your AGI and taxable income, which triggers many of the new laws that can result in a larger tax bill. The table on the following page shows some portfolio changes you may want to consider.

Technique	Benefits	Considerations
Invest in tax-exempt bonds	• Tax-exempt interest is excluded from Medicare surtax calculations and federal income taxation	• Tax-exempt bonds may not fit your asset allocation strategy • You may not be fully comfortable with the market, inflation and interest rate risks associated with tax-exempt bond investments • Certain municipal bonds may increase your AMT exposure or state income tax • If you are receiving Social Security benefits, tax-exempt interest is included in the calculation of provisional income and may affect the taxation of your benefits
Consider growth-oriented stocks for part of your portfolio (individually, through mutual funds, ETFs and/or advisory programs)	• Appreciation is not taxed until you sell the investment • Generally has little or no income to tax • Potential growth may allow you to accumulate more assets to help achieve your goals	• Little or no current cash flow to meet everyday expenses • Your investment is exposed to the market risk associated with this asset class
Convert traditional, SEP or SIMPLE IRA to a Roth IRA	• Roth IRA distributions after reaching age 59½ and meeting the five-year rule are federally income-tax-free • Future tax-free distributions from a Roth IRA are not considered investment income and will not increase your MAGI for calculation of the Medicare surtax	• In the conversion year, you boost your MAGI and taxable income (which could trigger or increase Medicare surtaxes) and increase your income tax liability • Conversion may impact taxation of Social Security benefits or amount of Medicare premiums • Withdrawals may be subject to a 10% federal tax penalty if taken prior to age 59½
Consider choice of business entity (for business owners)	• You are able to choose the tax structure that best suits your situation • A "C" corporation has a lower top tax rate than an individual who receives income through a pass-through entity ("S" corporation or partnership) • Earnings distributed from a pass-through entity are not subject to double taxation as with a "C" corporation	• Changing your corporate structure may increase certain costs and add regulatory requirements
Carefully review whether your business activities are characterized as passive or nonpassive	• Income from a nonpassive activity is not subject to the Medicare surtax • Losses from a nonpassive activity are not limited by the passive activity loss rules • You may be able to change your level of participation in an activity to meet the nonpassive standard	• It may not be possible to change your level of participation • Passive income is subject to the Medicare surtax • These rules are complex and should be closely reviewed with your tax professional

Qualified Roth IRA distributions are not subject to state and local taxation in most states. Qualified Roth IRA distributions are also federally tax-free provided a Roth account has been open for at least five years and the owner has reached age 59½ or meets other requirements. Withdrawals may be subject to a 10% federal tax penalty if distributions are taken prior to age 59½.

How will the timing of gain recognition affect your tax bill?

Developing a tax strategy is important. With these current tax provisions, meeting with your tax advisor early in the year is more crucial than ever. Incurring a sizable long-term capital gain may push you over one of the thresholds for the Medicare surtax or even into the 20% long-term capital gains tax rate. If you are selling a business or significant amount of property for a large gain, you may want to consider an installment sale rather than receiving a lump sum in any one tax year.

Work with your tax advisor to project your tax liability from all sources – wages, self-employment income, investment returns and sales, and perhaps others. Discuss how each of these income sources will be taxed and, for those you can control, evaluate whether it's better for your situation to trigger that income this year, next year or sometime in the future. Here are some examples:

With the current tax provisions, meeting with your tax advisor early this year is more crucial than ever.

Technique	Benefits	Considerations
Selling an appreciated, long-term concentrated stock position	• Typically helps diversify a portfolio and potentially reduce risk • You can choose to sell as much or as little as necessary to meet financial goals and control your tax situation • May provide additional spendable cash flow (depending on reinvestment or strategy considered)	• Triggers long-term capital gains tax • May incur the 3.8% Medicare surtax on long-term capital gains • Amount that exceeds the 39.6% tax bracket thresholds could trigger 20% (23.8% with surtax) long-term capital gains tax rate
Business or property installment sale	• May allow you to control cash flow and tax liability year-by-year	• Purchaser may not have flexibility to provide multi-year payments • Risk relating to ability of purchaser to continue payments across term of agreement • In all cases, most effective if you can keep your income below key tax thresholds
Establishing and contributing to a charitable remainder trust	• May contribute an appreciated, long-term concentrated position without current tax consequences • May increase your income stream • Helps meet your philanthropic goals	• Charitable deductions may be subject to phase-out rules (see page 4) • Gift is irrevocable; you no longer have access to the asset • You need to be charitably inclined
Like-kind exchange	• May defer gain by exchanging property for like-kind property • Gain or loss is deferred until the new property is subsequently sold	• Must be a property-for-property exchange; any money received would be taxable • Will not increase current spendable cash or result in additional liquidity, in many cases • Available only for property held for investment or productive use in trade or business

Are you subject to AMT?

The AMT calculation is separate from the regular taxable income calculation and requires you to add back certain tax deductions and income exclusions to your regular income tax to arrive at your alternative minimum taxable income. Your chances of paying AMT may increase if you have:

- Several dependents
- Interest deductions from home equity loans or refinanced mortgages that were not used to buy, build or improve your home
- Interest from certain private activity municipal bonds (AMT bonds)
- High ordinary income or capital gains
- High state and local taxes
- Exercised and continue to hold incentive stock options (ISOs)

Depending on your personal situation, other AMT adjustments may also apply. Even limited exposure to only one or two items that can trigger AMT may subject you to the tax. As a higher-income taxpayer, you should talk with your tax advisor about the possibility of incurring AMT. He or she may be able to do a projection to help evaluate your AMT potential. For more details, ask your Financial Advisor for a copy of our report, "AMT and the Individual Investor."

Considerations for stock-based benefits

Higher-income taxpayers are often employed at publicly traded companies and receive a substantial amount of their compensation from stock-based benefits, such as stock options, restricted stock, performance awards, etc. If this is the case, talk with your Financial Advisor about various strategies for managing these valuable benefits. You'll want to develop a plan to help you avoid stacking up and exercising too many grants in one tax year. You may also want to consider whether there is a benefit to disqualifying dispositions of ISOs in particular years to help reduce your AMT exposure. Overall, you should develop a strategy early in each tax year so you avoid last-minute transactions that could unexpectedly increase your tax liability.

Look beyond taxes with a team approach

Depending on your objectives and net worth, you may want to consider additional techniques, such as other charitable trusts, alternative investments, and insurance strategies. The tax code is now more complicated, and there is even more interplay between taxable income, AGI, tax brackets, and investment taxation. That's why you may benefit from talking with your entire team of advisors – your tax and legal advisors along with your Financial Advisor – early in the tax year. As a group, you can evaluate how any of the techniques in this report may help you meet your investment, legacy planning, philanthropic and tax-management goals.

Meet with your tax advisor throughout the year.

Your CPA or tax professional can help prepare a tax projection well before year-end and work with your other advisors to evaluate and implement strategies that may reduce your overall tax liability.

Call your legal advisor.

Many valuable estate planning strategies remain viable and meaningful alternatives to improve your legacy planning. Some strategies may help reduce current year's or future years' taxes and can work in tandem with income tax strategies your tax professional may have suggested. Your estate attorney can help identify and explain these strategies.

Talk regularly with your Financial Advisor.

Your Financial Advisor can give you a valuable, independent investment perspective on various tax and estate strategies you may be considering. He or she can also help you evaluate how certain strategies and investments complement each other and help maintain your focus on your long-term goals.

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