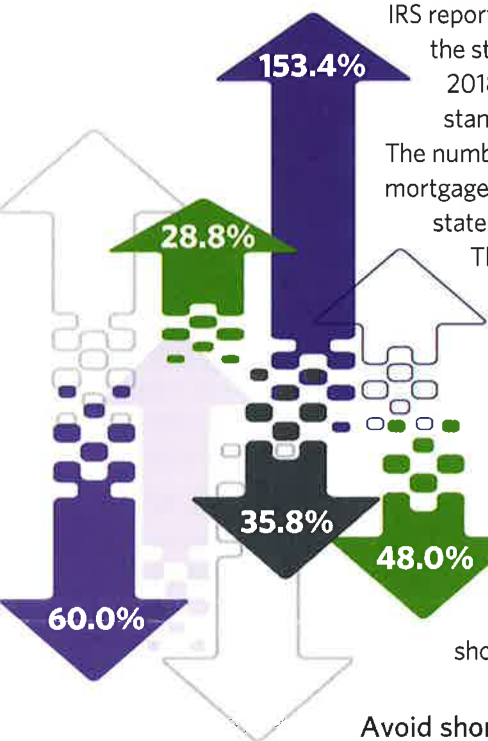
Q QUARTER NOTES

Fourth Quarter 2019

Paul R. Mancuso

Year-end tax and portfolio planning

The Tax Cuts and Jobs Act enacted in December 2017 eliminated the personal exemption and capped the deduction for state and local taxes at $10,000. These changes were offset by a dramatic increase in the standard deduction.



The tax law worked as intended, according to the latest IRS reports. The number of taxpayers claiming the standard deduction rose by 28.8% for the 2018 tax year, and the total dollar value of standard deductions increased by 153.4%. The number of returns claiming deductions for mortgage interest, charitable contributions, and state and local taxes fell by more than 60%. The dollar value of those deductions dropped 35.8% for charitable contributions, 46.5% for mortgage interest, and 48.0% for state and local taxes.

Traditionally, year-end tax planning concerns the timing of income and deductions. With so many now taking the standard deduction, timing issues have receded in importance. Still, even non-itemizers should keep several basic points in mind.

Avoid short-term gains

The tax rate on a capital gain from the sale of an asset held for more than a year is generally about half of that on the sale of

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Final moves for 2019

This has been a rather volatile year for many investors, with more than the usual number of uncertainties overhanging the markets. As the year comes to a close, take a hard look at your portfolio and your taxes. The new rules from 2017's tax reform should be familiar. Where do you stand? What tax moves or portfolio adjustments should be considered?

Next, has your portfolio gone out of balance? A passive approach leads to overweighting stocks in an up market. If that's you, are you comfortable with the additional risk that implies?

We can help you with evaluations such as these. We welcome your inquiries.

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Community Brokerage & Investment Services something held for a year or less. This can create a quandary. Should an investor lock in a gain while the price is high, or risk a market downturn by waiting until the longer holding period is satisfied? No doubt, in today's volatile financial markets, this call is often not an easy one to make. Still, a bias toward longer-term holding periods will lead to better overall tax results.

Use tax-deferred accounts wisely

There is a temptation to hold appreciating assets, such as stocks, in a tax-deferred account, such as a traditional IRA. Years of tax-free compounding are certainly attractive. On the other hand, all distributions from the traditional IRA will be taxed as ordinary income. There is no preferential tax rate for long-term holdings. What's more, the basis step-up at death doesn't apply to assets in retirement accounts. Accordingly, the better result for some investors will come from owning their appreciating assets in a taxable account, and investing their IRAs in bonds and other income-oriented choices.

The zero tax on some capital gains

Taxpayers in the lowest tax bracket pay no tax at all on their capital gains. Should the taxpayer experience a year of falling into that low bracket, it's a great time to harvest gains at no tax cost. The more likely scenario for an affluent family is in the realm of gifts. A grandparent who would like to give $15,000 to a grandchild, perhaps to help with higher-education expenses, would be well advised to instead give the grandchild appreciated securities. Assuming that the grandchild has only nominal income, the stocks may be sold without any tax drag on the proceeds.

Convert to a Roth IRA

Conversion of a traditional IRA to a Roth IRA is a taxable event, and the tax can be substantial. However, with the Roth IRA, all future income and capital appreciation has the potential of being fully tax free. Should a taxpayer find himself or herself in a lower bracket than usual, it well may be a good time to consider such a conversion.

See your tax advisors before making any final decision.

New boundaries

The AMT will snare fewer people in 2019.

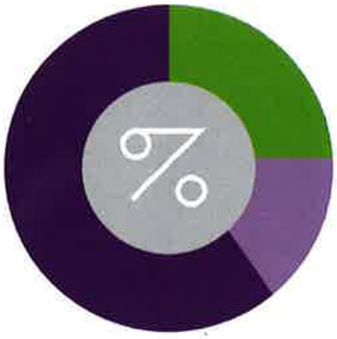
	AMT exemption
Married filing jointly or surviving spouses	$111,700
Married filing separately	$55,850
Single	$71,700
Head of household	$71,700

Break points for capital gains are higher.

	0% tax rate if taxable income is less than	15% tax rate if taxable income is less than
Married filing jointly or surviving spouses	$78,750	$488,850
Single	$39,375	$434,550
Head of household	$52,750	$461,700

Source: Internal Revenue Code; M.A. Co.

Taxpayers with taxable income above the break points pay a 20% tax on net capital gains and dividend income.



Rebalancing Act

There are many reasons for investors to be nervous these days. Increasing volatility in the financial markets. An aging bull market in stocks. A liquidity crunch in the repo market. Trade wars. Brexit. Political uncertainty in the Middle East and Hong Kong.

To ease the volatility and reduce risk in an investment portfolio, investors may balance their holdings among several asset classes that tend not to move in the same direction together. Over time the portfolio is likely to stray from that initial asset allocation plan. For example, an investor who begins with 60% in stocks and 40% in bonds may find that after a few years stocks make up 70% or more of the portfolio. Or, in a bear market, they may fall to 50%.

That may be a good time to rebalance the portfolio, to get back to the risk exposure that one was initially happy with. Or perhaps one should not wait for so large a deviation from initial objectives.

Writing in the *AAII Journal* of the American Association of Individual Investors, Sam Stovall compared the performance of six rebalancing strategies since 1976. Two of the approaches keyed rebalancing to the stocks getting too far from the objective, either 5% or 10% off target. The other four were time based:

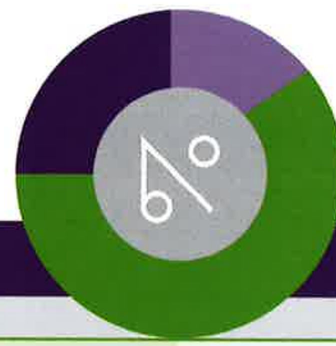
- quarterly;
- annually;
- every six months, on April 30 and October 31; and
- at the start of every presidential election cycle.

Stovall assumed a starting portfolio balance of 60% stocks and 40% bonds. The table below summarizes a portion of his findings.

Interestingly, despite the range in frequency of rebalancing from every three months to every four years, the range of outcomes in dollar terms was surprisingly narrow. The largest return came from not rebalancing at all, because that portfolio became over 90% invested in stocks by the end of the period. Accepting a higher equity exposure also meant that the portfolio without rebalancing had by far the worst single month in the study, a heart-stopping loss of 17%.

There is no one answer that is best for every investor. It comes down to what the investor is most comfortable with.

Are you satisfied with your investment strategy? Are you concerned about volatility in your holdings? We would be pleased to offer our expertise in this area. Call on us at your earliest convenience!



Rebalancing strategies compared

Frequency of rebalance	$1,000 on 12/31/75 became:	Best monthly change (%)	Worst monthly change (%)
Quarterly	$64,328	9.4	(13.3)
Every six months	$62,214	9.3	(12.9)
Annually	$63,939	9.1	(13.4)
Presidential cycle	$63,589	8.9	(14.0)
Stock allocation +/- 5%	$64,466	9.3	(12.9)
Stock allocation +/- 10%	$66,986	8.8	(13.5)
No rebalancing	$72,537	9.7	(17.0)

Source: Stovall, "A Question of (Re)balance," *AAII Journal*, August 2019

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Just Ask Us

What are my chances of being audited this year?

The higher your income, the more likely it is that you will be audited. According to the most recent IRS data from fiscal 2018, those with income of less that $500,000 have a less than 1% chance of being audited. Details are given in this table.

Adjusted gross income	% of all returns	% audited
$50,000 to $75,000	13.44	0.54
$75,000 to $100,000	8.66	0.46
$100,000 to $200,000	12.41	0.44
$200,000 to $500,000	3.72	0.53
$500,000 to $1 million	0.58	1.10
$1 million to $5 million	0.25	2.21
$5 million to $10 million	0.02	4.21
Over $10 million	0.01	6.66

Source: 2018 IRS Data Book

The audit rate has fallen in recent years. For example, in 2012 those in the $500,000 to $1 million bracket had a 3.57% chance of an audit, and those over $10 million had a 27.37% shot, with better than one in four top taxpayers being audited that year.