INVESTMENT STRATEGIES

John M. Roberts, Director of Research
J.J.B. Hilliard, W.L. Lyons, LLC
502.588.1165 / jmroberts@hilliard.com

9 November 2017

Taxing Thoughts: Year-end Tax Strategies

Initial ideas for tax strategies in 2017 and beyond

As in every year, changes may be required for investors planning investment tax strategies for 2017 and going forward. A tax reform bill is currently making its way through Congress. With taxes potentially changing, we will make some assumptions in regards to what we anticipate in the future, likely a higher standard deduction (making itemized deductions less attractive), ending certain deductions (for state and local taxes, medical expenses, etc.), and slightly lower rates.

We are not yet convinced some reform will be passed. This is especially true as even Republicans seem to be arguing over the bill; though both houses of Congress and the presidency are in Republican hands, they may not be able to agree. Following the collapse of the Republican Party's attempt to overturn the Affordable Care Act (ACA), President Trump has an incentive to show he is able to get something passed in relation to taxes.

However, differing opinions among the Republicans makes passage of any bill much more difficult. Making calls based on the current bill is somewhat speculative, although in large part these assumptions will accelerate deductions into the current year, which, we believe, in general is the appropriate suggestion anyway. While we will be outlining some thoughts based on the current tax laws, we will be adjusting our recommendations for year-end tax loss strategies to take into account these potential changes.

The 15% capital gains and qualified dividend tax rates are available for individuals with taxable incomes below $415,050 (singles) or $466,950 (married filing jointly), and 20% for those above those levels. Also, single taxpayers with modified adjusted gross incomes above $200,000 -- $250,000 for married taxpayers -- owe an additional 3.8% tax on dividends (Net Investment Income, or NIIT) and capital gains and 0.9% on earned income (Additional Medicare Tax) due to taxes under the ACA. This is in addition to the top marginal tax rate of 39.6%. With the ACA not being repealed we expect these taxes are likely to remain in the near term.

Note Important Disclosures on Pages 6-7
Note Analyst Certification on Page 6

High income investors may need to consider these additional taxes and potentially choose other types of investments, such as municipal bonds and funds which may be more attractive on a risk/reward basis than equities given the higher tax rates on equity dividends and capital gains. These taxes lower the after tax returns for high earners in those investments in comparison to the lower risk tax free bonds. Careful calculations are necessary to make future decisions on investment type for those in the upper end group, especially in light of the potential for these taxes going away under a Trump presidency.

Now, for the non-high income investor…

Getting Started

This time of year, many people are starting to arrange holiday parties and fill out holiday shopping lists. Tax planning may sound like something that can wait until April 15th rolls around, but we think virtually all investors (and for that matter taxpayers in general) should consider their tax situations well in advance of year end. Begin planning your year-end tax strategies as early in the year as practical.

As a first step, we suggest a thorough portfolio review would be in order. Identify any stocks that are potential sale candidates based on fundamentals, whether there is a profit or loss. Determine the holding period of each position.

Establishing Tax Losses

Capital losses generated can generally be used to offset any gains on a dollar for dollar basis or up to $3,000 in ordinary income once all gains are offset. For investors in a high tax bracket, the value of a security that has declined sharply can often be more valuable as a tax loss candidate than the security itself is currently worth. With tax rates potentially a little lower beyond the current year (although not for those with income above $1 million, as it looks like the 39.6% bracket will remain for those in that income range), we suggest taking those losses in 2017, rather than pushing them off.

These types of asset movements can also allow the investor to reallocate a portfolio to be more appropriate in the present environment, selling those losers and adding sectors and securities that are more attractive. If one of the securities being sold is in an attractive market sector, but the company has not performed well, the investor can sell that security and buy another in the same industry, but one that is more attractive fundamentally. Some of the specific strategies are outlined below.

Double Up, Sell Original Position After 30 Days

This may be an appropriate strategy for stocks that have experienced price weakness but whose fundamental outlook appears solid. In order to take advantage of certain tax maneuvers, one must act well before the end of the year. This includes doubling up on a losing position and selling out the original position prior to the end of the year to recognize a tax loss.

Because of wash sale rules, which require 30 days to elapse between the time a new position was established and the original one sold at a loss, the purchase needs to be made prior to 30 days before the end of the year. Should you choose to utilize this tax planning strategy, remember to sell the original high cost position, prior to the end of the year, to establish the loss.

Sell Now, Buy Back After 30 Days

Sell a losing position now and buy the security back in 31 days -- for this to be an appropriate strategy one must believe the security will be attractive for purchase a month into the future and unlikely to have a big move up in the interim. A risk to selling the stock now (without buying an offsetting position) is that the stock could potentially run up in the thirty days while the position is not held.

To limit potential risks, consider purchasing a similar stock when the first is sold. As an example, if you own a technology stock and want to sell it now for a tax loss, purchase another technology stock to offset the risk of an overall rise in the technology sector. While the company you purchase is not going to be exactly comparable to the one you sold, it may react to some of the same catalysts. Save any company specific issues with either company, the two should move somewhat in tandem.

Either way, it pays to not get too attached to any stock. When the 31st day rolls around, re-evaluate whether or not you want to own the stock. Don't reflexively buy back the stock. If it is too expensive at that time, walk away; there are likely other undervalued stocks around to purchase. **Don't get married to a stock.**

Sell Outright

If the thesis upon which a stock was originally purchased no longer holds, an outright sale of the position with no expectation for buying the stock back may be an appropriate strategy for establishing a loss. Securities that might be impacted by changes in the political environment or legislation should be looked at with this in mind. Also securities/sectors that might be seeing negative industry changes can be candidates for such selling.

Selling Gains

If there are stocks with a gain that are possible sale candidates, review the holding period. If it is close to a year, it may be wise to refrain from selling until a full year plus one day has passed to secure the 15% or 20% tax rate versus having them taxed at the top marginal tax rate, which can be as high as 39.6%. Pushing those off until 2018 is especially important in light of what we see as the likelihood of slightly lower taxes in 2018 and beyond. Remember, however, it is generally better to pay taxes on a gain than to wait and have a loss! **Never let tax considerations be the only determinant in your investment decisions.**

Another consideration on selling winners is the estate tax, which is expected to increase to $6 million in the first year of the new tax bill, and potentially go to zero sometime in the future. As such, investors may wish to not take gains for those positions one would like to pass on to the next generation, as that tax liability could potentially disappear when passed on to the next generation. However, one must not let such a benefit cloud an investor's judgement about selling stocks that might decline in price. After all, it is better to sell a stock and pay taxes than to pass what becomes a worthless investment to the next generation!

In general, here are our major conclusions. Sell losers to offset long-term gains, especially in the current year. If gains are still short-term at year end and it's unlikely there will be bad news that could drive the stock price lower, wait to sell winners until 2018 (or don't sell at all if one wants to pass them on to the next generation) after the shares have been held for 12 months, especially in light of the potential lower tax rates. Be careful of the wash sale rules, and don't let tax considerations alone drive the investment decision. If the investment should be sold today, sell it today even if you have to pay tax on the sale.

On the other hand, if you expect to be taxed at a lower tax rate this year and a higher tax rate next year, you may want to sell your winners this year and hold onto your losers until next year, taking into account the likelihood for lower taxes in future years. This assumes the capital gains rate is applicable in both years.

Also note: For those in the top tax brackets, municipal bonds in particular could be attractive, although one will need to see how changes in future tax rates develop. Therefore, we believe individual bonds or funds that invest in municipal bonds could prove good investments depending on what happens in the future regarding tax rates and the treatment of tax advantaged securities.

Also remember the Alternative Minimum Tax (AMT). Capital gains rates can be higher under the AMT. While it will likely be less an issue for those at the very high income levels, AMT could still snare those whose marginal tax rates fall below the highest levels. We note, however, if the tax bill passes as it is currently comprised, the AMT goes away.

Mutual Funds

Also understand the same strategies discussed above can be used when considering the sale of mutual funds. In fact, it is often easier to run these strategies with funds. Although their returns are likely to be very similar, selling one utility fund on which you have a loss and buying a different utility fund is typically not a wash sale. However, attention should be given to the impact of investor fees for various strategies as well as the length of time the investment has been held. It may also be advantageous to transact within fund families where fund changes might be made at net asset value.

Make sure not to buy a mutual fund that is about to go ex-dividend since you will pay tax on that dividend, which will reduce the value of the fund by the amount of the dividend. Many people reinvest the dividend in new shares anyway; it is typically better to buy your funds after any year-end dividend or short-term capital gain has been paid. If selling, consider doing so before the year-end dividend has been paid to escape any short-term capital gain distributions, which are taxable at ordinary income rates.

Caution: Reinvestment elections can act as a trigger to the wash sale rules, preventing your ability to recognize a loss. Be sure to consult a qualified tax advisor regarding this matter.

Dividend Strategies

Taxation of dividends should also play into your investment strategy. For the most part, corporate dividends are now taxed at the same rate as long-term capital gains (except under the AMT, which may also result in a higher tax rate like capital gains). Thus with high yielding securities, investors need to consider putting these in their retirement accounts and capital gains generating, low income paying securities with qualified dividends in their taxable accounts. As investors can determine when to take capital gains but not when to get dividends, structuring portfolios in such a way can limit the tax hit on dividends.

We suggest structuring your portfolio to have companies paying qualified dividends in your taxable account and those with non-qualifying dividends in your retirement or tax exempt accounts.

An exception is with a REIT or RIC whose distributions tend to be classified as a return of capital. This type of distribution generally is not taxable in the year received, but rather reduces the cost basis of the investment. These are also attractive investments for high income earners who can use these to generate income outside of their retirement accounts without the requisite hit to taxes.

Additionally, we urge investors to make themselves aware of the potential Master Limited Partnership (MLP) units have to generate Unrelated Business Taxable Income (UBTI) and related tax liabilities if held in an IRA or retirement accounts. For affected taxpayers with MLP units in taxable accounts, the 3.8% NIIT will apply to the MLP income as well.

You can also use these types of securities to help control amounts of taxable income reported in a custodial account for minors potentially staying below the threshold which would require the minor to pay taxes at the parents' rate.

Think of Your Retirement Plan

In addition to these recommendations, we feel investors should always max out their retirement accounts, whether it be an IRA, 401k, or similar employer-related plan. If you want to buy a stock and have not maxed out all of your retirement accounts, consider placing the money in your IRA or Roth IRA first, and then buy the stock there. You still own the stock and could experience a tax benefit. Of course, if your investment objective includes use of those funds before retirement, a taxable account is appropriate.

Remember, deductibility of retirement plan contributions may be impacted by circumstances which can vary from individual to individual. Please be sure to consult your tax advisor. Even if your income does not allow you to have a deductible IRA, you may wish to open a non-deductible IRA for some of your investments to take advantage of tax deferred appreciation.

Also, changes in tax laws now allow for all investors to convert their IRA accounts into Roth IRAs. Under such a transaction, one would pay ordinary income tax on the value of the IRA, and swap the assets into a Roth IRA, where there will be no tax on the qualified withdrawals, rather than paying ordinary tax on the appreciated value of the traditional IRA.

Unlike a traditional IRA, there is no minimum required distribution for the owner of a Roth IRA. Beneficiaries are subject to required minimum distributions on inherited Roth assets. For those converting IRAs with basis (arising from nondeductible contributions), remember that a partial conversion involves pro-rata allocation of basis to the converted amount -- no cherry picking is permitted under the regulations.

If one undertakes this transaction during 2017, taxes may not need to be paid until filing a 2017 tax return in 2018. Again, consult your tax advisor for exact information on such a transaction.

Miscellaneous Thoughts

Be mindful when re-balancing investments:

- Remember, the sale of a stock, bond (even tax-exempt!), or mutual fund is a reportable occurrence. Consider the timing of your action, determining whether you have a gain or a loss.

- Pay attention to the political situation and what the new administration and Congress are proposing on income and investment taxes. It is impossible to divine exactly what may be done and when, but it's important to pay close attention to what is being proposed.

- With the higher standard deduction being proposed, many investors may want to make deductible expenses, such as charitable gifts, this year. The higher standard deduction that the current bill calls for and elimination of some deductions may make these deductions useless.

- With it looking like medical expenses will no longer be deductible, those who can may want to take voluntary, deductible medical procedures this year, rather than waiting until 2018.

- Those looking to relocate may want to look at the tax impact of not being able to write-off state and local taxes and the impact on tax expense.

- If a large amount of cash is being held, consider investing in a Treasury bill now that matures in the following year and pays interest at maturity. In this situation, the interest will not be recognized in the current year.

- Don't forget miscellaneous itemized deductions. While they have to add up to 2% of your AGI (adjusted gross income) before they are deductible, there could be a large number of them, and most unreimbursed expenses relating to your job and investment advisory expenses may be included. Due to the 2% floor on such deductions, it often makes sense to attempt to bundle those all in one year, especially a year when an individual's income is a little lower to reduce the 2% threshold. With some of these also expected to be eliminated as deductibles, that is especially important this year.

Note: as income increases, these deductions are phased out according to IRS regulations. Be sure to consult a tax advisor regarding this matter and possible AMT triggers.

- Remember the needy. Rather than having a garage sale this year, go through your closets and clear out all of your unneeded or unwanted items and donate them to charity. The fair market value of the items is generally deductible against your adjusted gross income if you itemize, and you won't have all the costs and hassles involved in trying to sell the items yourself. It's reasonably easy to find fair market values for your items these days on the Internet [see eBay Inc. (EBAY-$37.01)], and you can help others while saving on your taxes! Be aware, some contributions may require donors to get an appraisal. As noted earlier, this is especially important this year.

  Keep in mind the effect of the phase-out provisions as your income increases. If you're donating with in-kind gifts of securities, be sure to only gift appreciated shares. Harvest losses on depreciated shares and gift the proceeds, but don't give away the tax benefit of the reportable loss.

Hilliard Lyons does not offer tax or legal advice. Please consult your advisor or attorney before making any decisions that may affect your tax or legal situation.

We recognize that each client's investment needs and goals are different. Opinions expressed here are subject to change without notice and do not take into account the particular investment objectives, financial situations, or needs of individual investors.

Stocks priced as of close, 8 November 2017.

Additional information is available upon request.

Analyst Certification

I, John Roberts, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

Investment Ratings

Buy: We believe the stock has significant total return potential in the coming 12 months. **Long-term Buy:** We believe the stock is an above average holding in its sector, and expect solid total returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years. **Neutral:** We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise. **Underperform:** We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings

1 - A large cap, core holding with a solid history. **2** - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks. **3** - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage. **4** - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base.

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	**# of Stocks Covered**	**% of Stocks Covered**	**Banking**	**No Banking**
Buy	32	29%	13%	88%
Hold/Neutral	73	65%	7%	93%
Sell	7	6%	0%	100%

As of 8 November 2017

Other Disclosures

Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation or needs of individual investors. Employees of J.J.B. Hilliard, W.L. Lyons, LLC or its affiliates may, at times, release written or oral commentary, technical analysis or trading strategies that differ from the opinions expressed here.

J.J.B. Hilliard, W.L. Lyons, LLC is a multi-disciplined financial services firm that regularly seeks investment banking assignments and compensation from issuers for services including, but not limited to, acting as an underwriter in an offering or financial advisor in a merger or acquisition, or serving as placement agent in private transactions.

The information herein has been obtained from sources we believe to be reliable but is not guaranteed and does not purport to be a complete statement of all material factors. This is for informational purposes and is not a solicitation of orders to purchase or sell securities.