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Guide...Protect...Preserve

7 Top Tax Incentives That Entice Investors

The U.S. tax code can be loaded with booby traps for unwary investors, but your advisers can help you avoid the dangers and reap potential tax rewards. Here are seven enticing incentives to consider:

1. Offsetting capital gains and losses: Your capital gains and losses from selling stocks and other assets may cancel each other and could reduce your tax liability. If your losses exceed your gains, you can use the excess to offset as much as $3,000 of highly taxed ordinary income. And you can use any additional losses in future years.

Even if you don't have offsetting losses, long-term capital gains on assets you've held longer than a year have a maximum tax rate of only 15% (20% for those in the top ordinary income tax bracket). Investors in the two lowest tax brackets benefit from a 0% rate on long-term capital gains.

2. Low tax rates for "qualified" dividends: Most dividends issued by domestic companies are "qualified" if they go to stockholders and mutual fund owners. In some cases, qualified dividends also may be paid by foreign corporations, including those whose shares are publicly traded as American Depositary Receipts (ADRs) or shares that otherwise are readily tradable on an established U.S. securities market.

Like long-term capital gains, qualified dividends have a maximum tax rate of 15% (20% for those in the top ordinary income tax bracket). And here, too, lower-income investors may qualify for a 0% rate.

3. Retirement accounts: The tax law encourages participation in retirement plans that employers sponsor. Typically, you can make pretax contributions to your account and invest the assets on a tax-deferred basis.

For example, you can defer up to $18,000 of salary to a 401(k) plan in 2016 ($24,000 if you're age 50 or older). In addition, your company may match part of your contribution. Distributions from your account, normally during retirement, generally are taxed at ordinary income rates.

4. Traditional and Roth IRAs: Your contributions to a traditional IRA may be wholly or partially deductible, depending on your annual income and whether you also participate in an employer-provided plan. Contributions of up to $5,500 for 2016 ($6,500 if age 50 or over) can grow on a tax-deferred basis, but payouts representing earnings and deductible contributions are taxed as ordinary income.

With a Roth IRA, in contrast, contributions are never deductible, but future distributions generally are exempt from tax. You will be required

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Retiring Abroad? Be Ready To Take The Bad With The Good

For some Americans, retiring to a tropical island is a dream that has turned into reality. However, it's not always what it is cracked up to be, according to a new survey by the Best Places in the World to Retire website.

The reasons for moving most often cited by respondents from three Central American retirement havens were hopes for a lower cost of living (87%), a less stressful lifestyle (82%), and an improved climate (74%). Two out of three isn't bad, because 84% say they indeed are able to live on less and 74% are enjoying the weather. But the 71% who say they have reduced their stress, though significant, falls short of the number of respondents who hoped that would result. The survey authors attribute this mainly to a slower pace of life and the need to temper expectations. For example, if you make a 4 p.m. appointment for someone to fix a leak, the worker might not show up until the next day. Americans typically aren't used to this.

Also, high on the list of things that the retirees miss are top-of-the-line goods and shopping (20%) and access to high-quality health care (16%).

Yet, overall, 85% of the survey respondents said they were happier living abroad than they were prior to the move.

Finally, 42% plan to never return to the U.S.; 37% aren't sure what they'll do; and 16% expect to come back due to aging or illness. Only 4% said they're coming back immediately while 3% anticipate moving back within five years.

Mary Jane Callaghan & Mitch Glicksman

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Tune Into The Tax Break For NUA

NUA isn't the latest channel available on your cable TV system. It stands for "net unrealized appreciation"—a little-known gem of a tax break for those who take payouts in the form of company stock from a 401(k) or other employer-sponsored retirement plan.

This tax law provision lets you benefit twice: once when you pay the tax on the plan distribution and once when you sell the stock.

If you receive a retirement plan distribution in company stock, you'll be taxed only on what you initially paid for it. You won't have to pay tax on any subsequent gains in value—known as net unrealized appreciation, or NUA. In contrast, cash distributions from your 401(k) normally are taxed as income, at rates up to 39.6%.

And what happens when you sell the shares you received from your retirement plan? Then you will be taxed on the difference between what you paid for the stock and its sale price. But that profit will be taxed at capital gains rates, and if it qualifies as a long-term gain—because you've owned the stock longer than one year—the maximum tax rate is only 15% (or 20% if you're in the top 39.6% ordinary income tax bracket).

But the tax breaks for NUA aren't automatic. The distribution must be:

- Made from a "qualified" retirement plan sponsored by your employer. (IRAs don't count.)
- Because of a triggering event—you died or became disabled, you reached age 59½, or you stopped working for the company sponsoring the plan.
- Taken in a single tax year.

Assuming you qualify, though, the tax savings for NUA can be substantial. Suppose that during the past 20 years, hypothetical investor Jane Doe has acquired 20,000 shares of company stock in her 401(k). The stock originally was bought for $5 a share, but now it's worth $50 a share, or a total of $1 million.

If Jane sells the stock within the 401(k) and then takes a cash distribution of the proceeds, the entire $1 million will be taxed as ordinary income. If Jane is in the 39.6% tax bracket, she'll be hit with a federal income tax bill of $396,000 (39.6% of $1 million). But if she instead takes the distribution as stock, not cash, she'll be taxed only on her original cost of $100,000, and she will pay only $39,600.

Now suppose that Jane sells the stock immediately for $1 million. Her $900,000 gain ($1 million - $100,000) is taxed as long-term capital gain at the maximum 20% rate, giving her a tax bill of $180,000. Add that to the $39,600 she paid on the distribution, and her total taxes are $219,600—or $176,400 less than she would have paid if she'd sold the stock inside her retirement plan. ●

Tax Rewards For Charitable Trusts

Are you thinking of giving a large gift to charity? A charitable trust can help you satisfy your philanthropic goals, preserve wealth for your heirs, and collect tax breaks, all at the same time. One of the most popular of these is the charitable remainder trust, or CRT.

A CRT requires you to give up control over the assets that you transfer into the trust and it's irrevocable. There's no going back, so make sure this charitable vehicle suits your needs before you commit to it.

Typically, you will set up a CRT with a particular charity you want to support. The charity must be approved by the IRS as a tax-exempt entity. During its term, you (or another income beneficiary or beneficiaries that you specify) receive regular payouts. The CRT may last for terms of years or for your lifetime. Finally, when the trust ends, whatever is left—the remainder—goes to the charity.

There are three main tax advantages to this setup:

1. Regular income tax: You're entitled to a current tax deduction for the projected value of the remainder that will go to the charity at the end of the trust's term. Your tax adviser and charity officials can help determine the amount of your deduction.

2. Capital gains tax: If you transfer appreciated assets into the trust you won't owe any tax on the appreciation. And if the charity sells property from the trust and turns it into cash, you don't have to worry about capital gains tax then, either. But you pay income tax on the annual payments you receive.

3. Estate tax: When the remainder eventually goes to the charity at the end of the trust, those assets are removed from your taxable estate. So there aren't any estate tax concerns with a CRT.

Let's not forget that you'll be receiving annual income from the CRT.

Dynasty Trusts: A Gift That Keeps On Giving

Would you like your assets to last forever? Of course, there are no guarantees, but a “dynasty trust” could help you preserve wealth for your heirs indefinitely. As the name implies, this type of trust is designed to span several generations, barring drastic changes in applicable laws or your family’s financial circumstances.

Under a common law principle known as the “rule against perpetuities,” trusts normally are required to have a beginning, middle, and an end. This rule was adopted in many states, establishing an expiration date for trusts of 21 years after the death of a potential beneficiary who was alive at the time of the trust’s creation. California and other states have adopted a variation of that rule with a limit of about 90 years. Delaware is among a few states that have repealed the rule completely and actively encourage people to set up dynasty trusts in those states.

With a dynasty trust, you transfer selected assets—perhaps stocks, bonds, real estate, or a combination of those—to a trust managed by an independent trustee. The trust can be created as an “inter vivos” transfer during your lifetime or a testamentary transfer through your will. Once established, the trust is irrevocable—you give up control over the assets and the right to change beneficiaries.

The trustee invests the trust assets. Depending on the terms of the trust, income may continue to accumulate within the trust or it could be paid out to beneficiaries, usually your descendants. You might name your adult children as the initial beneficiaries, to be followed by your grandchildren and great-grandchildren. The trustee also may have discretion to invade the trust principal for the health, education, support, and maintenance of beneficiaries or for other reasons.

By letting you designate the ultimate beneficiaries of the trust at the outset, this arrangement gives you some control over where the assets end up. In addition, a dynasty trust could help you protect some kinds of assets from creditors.

But a dynasty trust also may help reduce potential estate taxes. Under current rules, everyone is entitled to a generous estate and gift tax exemption of $5.45 million in 2016, which is indexed for inflation, and likely will rise in future years. This exemption is “portable” between spouses, which enables you to use any leftover amount not used when your spouse died. Similarly, while there is a generation-skipping transfer tax (GSTT) that applies to most transfers that skip a generation, including those made to a trust, that same exemption amount applies to the GSTT.

When you transfer assets to a dynasty trust, the transfer is potentially subject to federal gift tax—if its value exceeds $5.45 million. But future appreciation of those assets won’t be taxed, and that growth could benefit multiple generations of your heirs.

For example, suppose you and your spouse transfer $10 million to a dynasty trust. That gift isn’t taxed because it is less than the total $10.9 million combined exemption that you and your spouse are allowed. But by the time both of you have died, suppose the assets have grown to be worth $5 million more than your combined exemption would have covered. Without a dynasty trust, your family would have to pay a 40% estate tax, or $2 million. The estate tax bill for the dynasty trust is zero.

Of course, there are other considerations, including income taxes, which the trust must pay each year on investment earnings. For this reason, dynasty trusts often are funded mainly with assets that don’t produce current income—growth stock that doesn’t pay dividends, for example, or tax-free municipal bonds. Life insurance policies also could be transferred to a dynasty trust.

Just keep in mind that these trusts are complex arrangements, and you’ll need the help of an experienced estate planning specialist to create one that can benefit your family for generations to come. ●

It can be structured in one of two ways, which must be determined when you set up the trust. You can’t change your mind later. Here are the two ways:

- **Fixed annuity method:** The CRT pays out a fixed dollar amount each year. So even if trust earnings fall, you’ll still receive the same amount of money.
- **Percentage of assets method:** Another version, which is more common, is to base the annual payment on a percentage of assets. For instance, you might arrange to receive 6% of the value of the trust assets each year. Accordingly, your annual 6% payments generally will provide larger payouts over time, assuming the assets go up in value, but the amounts are based on market conditions.

In any event, the IRS requires you to receive at least 5% of the value of the trust each year and the charity’s remainder value must be at least 10% to preserve the tax breaks.

This is just a brief overview of CRTs. For more information about this rewarding tax planning technique, reach out to your advisers. ●

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Seek The Comfort Of A Pet Trust

Is your pet practically a member of the family? If so, you're certainly not alone, as many pet owners would go to extreme lengths to protect the well-being of their animal companions. In fact, you might even want to spell out plans to care for Fido or Tabby in a legally binding document, especially if you're fearful that your pet will live longer than you do.

"Pet trusts" have been around for years, but their popularity has been rising recently. In 2016, Minnesota became the last state in the nation to approve such arrangements. Now a pet trust can be established with legal authority anywhere in the United States.

As the name implies, a pet trust is a legally sanctioned arrangement that provides for the care and maintenance of one or more companion animals. Typically, the pet owner—called either the "grantor" or "settlor"—sets up the trust and designates a trustee to hold assets for the benefit of the pet. The trustee makes payments out of the trust funds as needed.

Depending on state law, a pet trust may last as long as 21 years or until the death of the pet, whichever comes first. In some states, the trust may continue even longer than 21 years.

The trust may provide specific instructions regarding the care of the pet that the trustee will be required to carry out. For example, if you own a cat that prefers a certain brand of food or your dog enjoys regular romps in the park, those particulars may be included in the trust. You also can impose requirements for regular visits to a vet.

Just like a trust for an elderly person, a pet trust may provide instructions for care in case the animal becomes ill or otherwise incapacitated. You know your pet better than anyone else, so describe the type and length of care your pet should receive.

Besides designating a trustee, as well as a successor and contingent trustee, you should identify your pet to avoid any potential fraud problems; detail your pet's standard of living and care; determine the amount of funds needed for your pet's care; designate a remainder beneficiary in the event the funds in the pet trust aren't exhausted upon the pet's death; require periodic "inspections" by the trustee to ensure that the pet is being properly taken care of; and list instructions for the pet's burial or other disposition.

Best of all, a pet trust offers its owner peace of mind. Instead of leaving matters to chance, you will know that your long-time companion will be cared for until the end of its life. ●

7 Top Tax Incentives

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to take distributions from a traditional IRA after age 70½, but that's not required for a Roth. You can convert assets from a traditional IRA to a Roth but most, or all of the amount you convert will be taxable as regular income.

5. Real estate: This investment has a unique status in the tax law. Not only can you write off certain expenses—including mortgage interest, property taxes, repairs, insurance, utilities, etc.—to reduce taxable income from the property, but you also can recoup the cost of the building through annual depreciation deductions.

Other tax rules may apply, including limits for losses claimed for "passive activities." Generally, passive losses can't exceed the amount of passive income, but a special exception may allow a limited write-off of up to $25,000 for active participants in rental activities.

6. Oil and gas: If you invest in an oil and gas deal, you may benefit from deductions for drilling costs, depletion deductions, and the low tax rates on long-term capital gains when you sell your interest.

Write-offs may be limited by the passive activity rules, as they are for real estate, but some investors may qualify for an exception. If you have a "working interest" in an oil and gas partnership, you're exempt.

7. Life insurance: If you acquire either permanent or temporary life insurance for yourself, your family is in line for tax benefits when the proceeds are paid. The death benefit for a life insurance policy is completely exempt from income tax. What's more, there's no current tax due on any buildup of cash value.

The death benefit on your life insurance could be subject to estate tax, but you may be able to avoid that by transferring ownership of the policy to an irrevocable life insurance trust (ILIT).

This isn't a complete list of tax breaks for investors, but these seven provisions are among the biggest and best in the tax code. ●

Evergreen Financial Associates, LLC • www.efallc.com
Mitch Glicksman • 8180 North Hayden Road, Suite D203, Scottsdale, AZ 85258 • Toll Free: 888.865.4449 • Phone: 480.951.6536 • Fax: 480.922.3007
Mary Jane Callaghan • 300 C Lake Street, Ramsey, NJ 07446 • Phone: 201.934.1818 • Fax: 201.934.4040
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