The New Three-Legged Stool ….Update

June 2010

Volume 1 Issue 11

Inside this issue: Page

What You Should Know About Asset Allocation in Taxable, Tax-Deferred and Roth Accounts 1
Tax Related Pitfalls 2
How you save is just as important as how much you save 3
The accountant and Financial Adviser need to work together 4
Rick's Tips - The tax significance of Municipal Bonds and their risks 4

What You Should Know About Asset Allocation in Taxable, Tax-Deferred and Roth Accounts

To help illustrate the importance of including after-tax strategies in your retirement plan, consider the following:

> Shirley Bachman was a retired widow who had accumulated what she thought would be a comfortable savings for retirement. Her financial assets totaled $1 million, and it was split nearly equally between an IRA and a taxable account. She counted on the income from her investment accounts, Social Security, and a small pension to make ends meet.
>
> When Shirley turned 70½, she had to begin to take her required minimum distribution (RMD) from her IRA, and the additional taxable income was making 85% of her Social Security taxable. She found making the higher quarterly estimated tax payments was straining her budget. What she needed was a more tax-efficient way to generate income.
>
> Shirley lived in a single family home she'd raised her children in and didn't really want to move. However, she was considering the option of selling her home and moving into a smaller condominium that would hopefully be less costly to maintain.

When Shirley came to me for financial advice, I found she considered herself to be a moderate investor. She knew growth would be needed to help keep pace with inflation. Her accounts were invested equally in stocks and bonds. Like most Americans, she had invested both her taxable account and IRA the same way. Could there have been a better way to allocate the investments from a tax-efficient standpoint and still maintain the moderate risk allocation?

The answer was yes—an answer supported by a study from Robert Dammon and Chester Spatt, finance professors at Carnegie Mellon. Dammon and Spatt published a study in the *Journal of Finance*[1] that showed some simple rules of thumb. Their first assertion was investors should put their taxable fixed income investments (government bonds, corporate bonds, and certificates of deposit or CDs) along with real estate investment trusts (which are mostly taxed at ordinary income tax rates) into tax-deferred accounts. Ordinary income tax rates can be as high as 35%, but long-term capital gains and qualified dividends are taxed at a maximum rate of 15%, so the stock assets should be placed in taxable accounts. The study found this allocation was beneficial even for those who trade stocks frequently.

> *Note: calculating taxes can get complicated, since it depends on how long you hold the security and whether the accounts will be subject to state income tax.*

Thus, putting the most highly taxed assets into tax-deferred accounts like an IRA or 401(k), and holding those with tax preferred treatment like stocks and stock mutual funds, which generate long-term capital gains and qualified dividends, can easily add 20% in portfolio value over time. This is especially true for middle-aged investors who have a longer period to compound.

Some investors would argue it doesn't matter if you hold bonds in a taxable account, because they'd only invest in tax-free municipal bonds. Dammon and Spatt's study concluded municipal bonds should only be used in taxable accounts after the tax-deferred accounts have been filled with taxable bonds. The reason is municipals historically pay a much lower yield than taxable bonds. Earning the higher returns on the taxable bonds in a tax-deferred account more than offsets the tax paid when you have to start drawing from those accounts and paying tax on the distributions.

The disadvantage is compounded if you end up holding stocks in the tax-deferred account, because you're holding municipal bonds in the taxable account. You lose the 15% tax treatment on your capital gains and dividends, because all withdrawals from tax-deferred accounts are taxed as ordinary income. The investor could end up paying as high as 35% on the capital gains earned from his or her stock holdings in an IRA.

***

[1] Robert M. Dammon, Chester S. Spatt, and Harold H. Zhang, "Optimal Asset Location and Allocation with Taxable and Tax-Deferred Investing," *The Journal of Finance*, Vol. LIX, No. 3 (June 2004): pp. 999-1038

Tax Related Pitfalls

Tax-efficient investing requires active involvement. That starts with looking for tax-efficient mutual funds. You also need to monitor the portfolios so losses are harvested to offset gains. In addition, you must pay attention to holding periods to ensure the asset has been held at least 12 months.

Start by screening your funds for performance and then for tax efficiency. Separate your list of funds that meet your performance criteria by tax efficiency. You don't want to completely exclude funds that aren't tax-efficient, because these can be held in your tax-deferred accounts. You don't need or want to be in a tax-efficient fund with your qualified retirement plan. There are trade offs between performance and tax efficiency. Returns tend to be lower in tax-efficient funds. Inside a qualified plan, you want the managers to be more aggressive and make moves in the portfolio, if they considered the tax consequences, they might choose not to make.

One of the biggest mistakes investors make is failing to harvest losses in their portfolio. A lot of people think just because an investment is worth less than they paid for it, they haven't really lost any money, because they didn't sell it. You should start by evaluating the investment. If you had cash today, would you still invest in that same position, or are there other opportunities that look better? If the answer is that you would not invest in the position, take the loss and reinvest elsewhere. The loss could be worth thousands in saved taxes.

The reason most investors don't use this strategy is because loss harvesting is labor intensive—and nobody wants to admit to taking a loss.

***

Recommendations for Investing in a Tax-Efficient Way:

- Investing tax-efficiently is a balancing act between diversified asset classes that minimize taxes yet still achieves superior returns.
- The tax decision should never overrule the investment decision.
- Index funds, exchange-traded funds, and tax-efficient mutual funds may be good tax-efficient investment choices.
- In terms of your retirement accounts, tax efficiency shouldn't be your goal; your retirement account investments should be more aggressive so they result in bigger returns over the long haul.
- Review your portfolio regularly, and don't be afraid to harvest losses—especially since you may be able to take the losses as a tax write-off.

647 East Roseville Road
Lancaster, PA 17601
Phone: 717-560-3800
Toll Free 1-888-876-3437
E-mail: mark@rodgers-associates.com
www.rodgers-associates.com

NEED A SECOND OPINION?

Is your financial plan on track? Are your assets coordinated?

Is your retirement plan tax efficient?

Are you satisfied with your current advisor or do they only call to sell you something?

Rodgers & Associates can help.

We offer a no obligation consultation, evaluate your current plan and offer suggestions to improve it.

Call Mark Eisenberger at (888) 876-3437 or email him: Mark@Rodgers-Associates.com to make arrangements for a complimentary, no obligation consultation.

How You Save is Just as Important as How Much You Save

Lee Eisenberg wrote a book in 2006 about the amount of money and resources people will need to enjoy the active life they desire, especially post-career, titled ***THE NUMBER:*** *A Completely Different Way to Think About the Rest of Your Life*. Theoretically there is an amount of money that each person needs to have in order to maintain their lifestyle through the end of life expectancy. That number could be significantly lower if it was saved tax-efficiently rather than saved all in a tax-deferred account where every dollar will be taxed as soon as you try to spend it.

Dan and Teri Carter are new retirees. Dan retired two years ago with a small pension. He started drawing Social Security and has $600,000 in an IRA rollover account from his old 401(k). Teri has just accepted an early retirement offer from her employer. She will also have a small pension and one-year of severance. Her 401(k) account is worth $700,000. They have no other savings.

They need $100,000 per year of spendable income to maintain their lifestyle in retirement. Their two pensions amount to $25,000 per year. Social Security for both of them pays another $30,000. They will need to withdraw the difference of $45,000 from their retirement accounts to meet their income goal. A $45,000 withdrawal from $1.3 million account balances is a withdrawal rate of 3.5%. A prudent withdrawal rate is 4% or less. The Carters wouldn't have any problem with their retirement plans if it wasn't for income taxes.

All of their pension income is subject to tax. All of their retirement account withdrawals are subject to tax. 85% of their Social Security benefits are subject to tax. The Carters claim the standard deduction and two personal exemptions. They will need to forfeit $12,100 to the IRS. That's 27% of their retirement account distributions!

In order to net $45,000 from their retirement accounts, they would need to take $61,000 per year and pay $16,000 in taxes. This is because every dollar they take from their retirement account to pay taxes is itself subject to tax.

However, $61,000 is a withdrawal rate of nearly 5% per year and would be too high for their accounts to support.

The Carter's should have had a balanced approach to retirement savings. Saving their money equally between tax-deferred accounts (their 401(k) plans); after-tax accounts and tax-free accounts (Roth IRAs). They would not have received the tax deductions as they accumulated their savings, but let's look at the impact on their retirement income.

The $45,000 of income they need will come equally from their three sources of savings. $15,000 from the 401(k)/IRA accounts will still be taxable. $15,000 from the after-tax account will be partially taxable but at capital gains tax rate. The tax rate on capital gains is currently 0% for the Carter's because they will be in the 15% bracket now. $15,000 from the Roth IRA will be totally tax free. Their tax bill has dropped to $5,000. This is a nearly 60% decrease in taxes!

Their tax bill can be paid from their non-taxable accounts so it will not increase the amount. The total withdrawal amount of $50,000 per year is under the 4% target.

You need to start planning now to balance your retirement savings while the tax laws are still favorable. The current low tax rates are scheduled to increase on January 1, 2011. Congress could act sooner to increase rates but it is unlikely to do so until the economy recovers.

***

The New Three-Legged Stool

A Tax Efficient Approach to Retirement Planning

By Rick Rodgers

Imagine you're playing a game called Retirement Distribution. Your opponent, the IRS, wrote the rules of the game. The secret to winning this game is to keep the IRS out of your financial affairs before they have the right to interfere. To win, you will need a guide to the fine print in the rule book, and a sound strategy.

www.thenewthreeleggedstool.com

The Accountant and Financial Adviser Need to Work Together

High net worth households have traditionally used their accountant for tax advice and their financial advisor for investment advice. But to get the most tax-efficient investment strategies and lower income taxes overall, both need to work together. No one person has a monopoly on all the good tax planning ideas. Tax planning is an ongoing process. Too many people wait until March to even think about income tax planning. March is just too late for the accountant to make a big difference in the tax bill.

Just over a quarter of the affluent investors think differently and more frequently about their taxes during year-end and the first quarter than at other times of the year. Financial advisers need to partner with the client's accountant to be in a better position to help reduce income taxes throughout the year. One of the financial adviser's roles will be to educate and inform the client on various ways for them to reduce their tax liability and then consult with the tax planner on the best strategies to implement.

Charitable giving is another important tool that financial advisers can use to reduce taxes. This will often involve the client's estate planning attorney who can offer advice on Charitable Remainder Trusts, Charitable Lead Trusts, and other techniques that many be appropriate to meet the client's charitable goals as well as tax reduction goals. The attorney becomes the third member of the tax planning team. High net worth households will feel more confident about their tax strategy when they have their financial adviser, accountant and attorney working together to develop a cohesive tax minimization strategy.

***

Rick's Tip -The Tax Significance of Municipal Bonds and their Risks

Municipal bond interest is generally exempt from federal income tax and, in some cases, state and local taxes as well. Municipal bonds are generally considered to be second in safety behind bonds backed by the federal government. These two features make investing in municipal bonds very popular. However, it is important to consider 1) municipal bonds are not risk free, 2) you have alternatives that may be better for your particular circumstance and 3) how municipal bonds fit in with your overall investment and financial plan.

Municipal bonds carry the same two major risks that all fixed income investments contain. The first is interest rate risk. Interest rate risk is when the value of the bond moves up or down when interest rates rise and fall. Bond values typically decline when interest rates rise. Nobody wants your five percent bond when they can buy a new one paying six percent. That is unless you discount the price of the bond. The reverse is true when interest rates decline. The value of a bond will typically rise. Longer-term bonds tend to fluctuate in value more than shorter-term bonds because at maturity, the bond will return to face value. To compensate for interest rate risk, longer bonds typically have higher yields than short- or intermediate-term bond funds.

The second major risk is credit risk, also known as default risk. Municipal bonds are typically debt obligations of state and local agencies that are dependent on tax receipts. There is a lot of concern in today's economic environment that tax receipts are down which raises the risk of default. Moody's Investors Service recently assigned a negative outlook to the creditworthiness of all local governments in the United States.

Interest rates are currently at historically low levels and the current negative outlook of creditworthiness for governments should cause everyone to carefully consider investing in municipal bonds. A safer alternative may be to use intermediate-term municipal bond funds instead of individual bonds. Avoid the long-term bond funds because they tend to invest in bonds that have maturities of 10 years or more which will be more vulnerable to increasing interest rates. Intermediate-term bond funds or intermediate-term tax-exempt ETFs are likely to be less volatile.

Yields on municipal bonds are generally less than taxable bonds. That's why it's important to have a financial plan in place and a strategy to implement it so you can easily determine if municipal bonds have a place in that strategy. Municipal bonds, just like any investment, should only be considered in the context of your overall financial and investment plan.

Information and examples in this article are of a general nature. The information reflects the opinion of Rick Rodgers and Rodgers & Associates on the date written and is subject to change at any time without notice. Due to various factors, including changing market, tax, and legal considerations, the content may no longer be reflective of current opinions or positions. The information provided should not be deemed to constitute financial, investment, tax or legal advice.