Planning Opportunities in Light of ATRA 2012: What Do We Do Now?

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Building a New Foundation of Knowledge

- American Taxpayer Relief Act of 2012
  - Income Tax Changes
  - Capital Gain Changes
- Patient Protection and Affordable Care Act
  - Medicare Surtax

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2013 Ordinary Income Tax Rates

10%, 15%, 25% and 28% rates from Bush Administration tax cuts made permanent

33% and 35% rates made permanent up to certain threshold levels—

Single taxpayers	$400,000
Head of households	$425,000
Married filing jointly or surviving spouse	$450,000
Married filing separately	$225,000

Amounts of income above these threshold levels taxed at 39.6%

Threshold amounts adjusted for inflation

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2013—Long-Term Capital Gains & Dividends

- Tax rate increases to 20% for taxpayers with income above the threshold amounts listed on the previous slide
  - As these taxpayers will be above the threshold amounts for the 3.8% surtax, their capital gain rate will actually be 23.8%
- Maximum rate stays at 15% for taxpayers with lower incomes
- Qualified dividend treatment is made permanent
- Under the original Obama Administration proposal, the rate on dividends would have been the ordinary income rate

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Phase-out of Personal Exemptions and Itemized Deductions

- Phase-out of personal exemptions (PEP) and limitations on itemized deductions (Pease) as income rises above the following threshold amounts--

Single taxpayers	$250,000
Head of households	$275,000
Married filing jointly or surviving spouse	$300,000
Married filing separately	$150,000

- Amounts will be indexed for inflation

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Phase-out Of Personal Exemptions and Itemized Deductions

- PEP reduces personal exemption by 2% for-
  - every $2,500 of income above the threshold amount for single taxpayers
  - every $1,250 of income above the threshold amount for married taxpayers filing jointly

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Pease Limitation

- Pease cuts itemized deductions by 3% of AGI above the threshold amounts up to a maximum of 80%

- Deductions not included:
  - Investment Interest
  - Medical Expenses
  - Casualty, theft and wagering losses

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Comparison of 2012 and 2013 Rates

	2012	2013	2013	Adj
Top Ordinary Income Rate - Salary	35%	39.6%	41.688%	*
Top Ordinary Income Rate - Investment Income	35%	39.6%	44.588%	**
Top Capital Gain Rate	15%	20%	24.988%	***
Top Tax Rate on Dividends	15%	23.8%	24.988%	***
Payroll Tax	10.40%	12.4%	12.4%	
Medicare Surtax on Investment Income	0%	3.8%	3.8%	****
Payroll Surtax on Earned Income	0%	0.9%	0.9%	
Estate Tax Rate	35%	40%	40%	
*Includes phase-out of deductions (1.188%) and 0.9% healthcare wage tax				
**Includes 3.8% Surtax and phase-out of deductions (1.188%)				
***20% base rate plus 3.8% Surtax plus 1.188% adjustment for itemized deductions				
****Threshold amounts are $200,000 for single filers, $250,000 for joint returns,				
and $11,950 for Estates/Trusts				

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Recap: Threshold Amounts

Summary of Thresholds		
	Single	Married
3.8% Surtax (MAGI)	$ 200,000	$ 250,000
PEP & Pease (AGI)	$ 250,000	$ 300,000
39.6% Rate	$ 400,000	$ 450,000

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2013 Planning for Trusts & Estates

- Selection of fiscal year
- Distribution planning
  - Income
  - Capital gains
- Investment allocation
- Low turn over investment strategies
- Real estate strategies

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Roth 401(k) Conversions

- Under prior law, taxpayers had to be at least 59 ½ or leave their employer to convert a traditional 401(k) to a Roth 401(k)
- Section 902 of the fiscal cliff legislation lifts these restrictions
- Claimed to raise $12 billion in revenue over 10 years
- Raises revenue in short term but likely to be revenue neutral or a revenue loser long-term
- Taxpayers convert to a Roth because they think it will mitigate State and/or Federal income taxes in the long run

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Creating Tax Alpha

Alpha

- In Modern Portfolio Theory (MPT), *Alpha* is the excess return of a risk-adjusted portfolio relative to the portfolio's benchmark.
  - In simple terms, by how much did your portfolio beat "the market"

Beating the Market

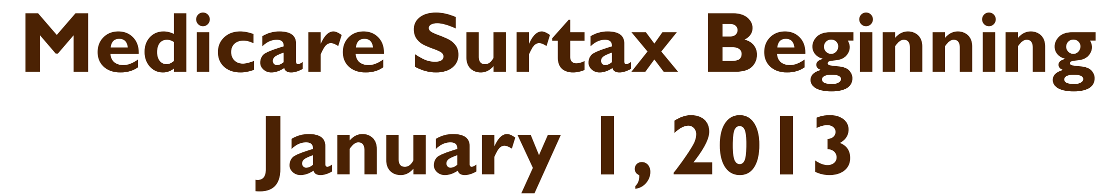
- According to Merrill Lynch, only 39% of mutual funds beat the S & P 500 in 2012
  - Historically, less than 50% of funds beat the market in a given year.
  - This does not include funds that are wound down due to poor performance.

MPT and "Tax Alpha"

- One of the main drawbacks of Modern Portfolio Theory is that it neglects transaction costs and taxes.
  - A 5% return taxed at 23.8% is really a 3.81% return – will that still beat the market?
- "Tax Alpha" is enhancing a portfolio's true return by planning for less taxation

“Tax Alpha”

- Asset Location
  - IRA
  - Roth IRA
  - Brokerage (taxable) account
- Asset Relocation
  - Roth/Life Insurance
- Deferral/Turnover


Medicare Surtax Beginning
January 1, 2013

3.8% Medicare "Surtax" Overview

Investment Income

- Beginning with the 2013 tax year, a new 3.8% Medicare "surtax" will apply to all taxpayers whose income exceeds a certain "threshold amount". This new "surtax" will, in essence, raise the marginal income tax rate for affected taxpayers.

- Thus, a taxpayer in the 39.6% tax bracket (i.e. the highest marginal income tax rate in 2013) would have a marginal rate of 43.4%!

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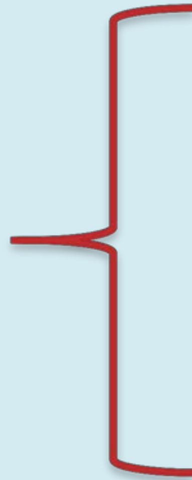
3.8% Medicare “Surtax” Overview

APPLICATION TO INDIVIDUALS

The Medicare Surtax is equal to:

3.8% X
the lesser of



1. Net Investment Income

   OR

2. The excess (if any) of –
   - “Modified Adjusted Gross Income (MAGI)
   - “Threshold Amount”

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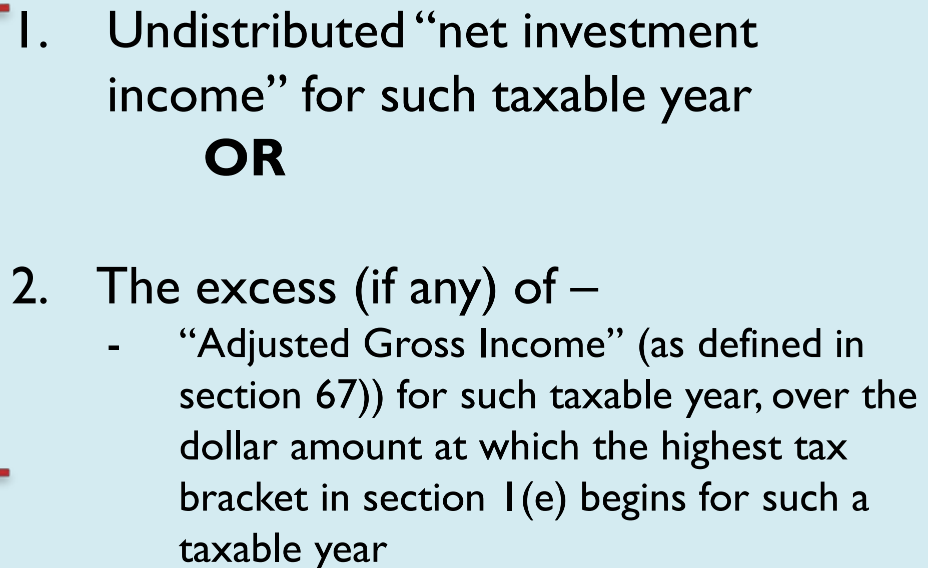
3.8% Medicare "Surtax" Overview

APPLICATION TO ESTATES AND TRUSTS

The Medicare Surtax is equal to:

3.8% X
the lesser of



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3.8% Medicare "Surtax" Overview

Three critical terms associated with the 3.8% Medicare surtax:

- "Net investment income" (NII)
- "Threshold amount" (TA)
- "Modified adjusted gross income" (MAGI)

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3.8% Medicare "Surtax" Overview

NET INVESTMENT INCOME

Includes:

- Interest
- Dividends
- Annuity Distributions
- Rents
- Royalties
- Income derived from passive activity
- Net capital gain derived from the disposition of property

Does NOT Include:

- Salary, wages, or bonuses
- Distributions from IRAs or qualified plans
- Any income taken into account for self-employment tax purposes
- Gain on the sale of an active interest in a partnership or S corporation
- Items which are otherwise excluded or exempt from income under the income tax law, such as interest from tax-exempt bonds, capital gain excluded under IRC 121, and veterans benefits

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3.8% Medicare "Surtax" Overview

"Threshold amount": is the key factor in determining the "lesser of" formula for purposes of calculating the surtax.

Threshold amounts

- Single taxpayers - $200,000
- Married taxpayers - $250,000
- Estates/trusts - $11,950 (i.e. top income tax bracket in 2013)

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3.8% Medicare "Surtax" Overview

"Modified adjusted gross income" ("MAGI"): is the amount that is compared to the "threshold amount" to determine the "net investment income" that is subject to the surtax.

MAGI equals:

- Adjusted gross income (i.e., Form 1040, Line 37) *PLUS*
- Net foreign earned income exclusion (i.e., gross income excluded under the foreign earned income exclusion less certain deductions or exclusions that were disallowed due to the foreign earned income exclusion)

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3.8% Medicare "Surtax" Overview

Example 1

John

- Single Taxpayer
- $100,000 of Salary
- $50,000 net investment income

MAGI is $150,000

3.8% Surtax would NOT apply

MAGI is less than threshold

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3.8% Medicare "Surtax" Overview

Example 2

Linda

- Single taxpayer
- $0 employment income
- $225,000 net investment income

Excess of	
MAGI	**$225,000**
Threshold	**-$200,000**
	= $25,000

3.8% Surtax would apply to $25,000

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3.8% Medicare "Surtax" Overview

Example 3

Tina & Terry

- Married, filing jointly
- $300,000 combined salary
- $0 net investment income

3.8% Surtax would NOT apply

Wages Exempt

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3.8% Medicare "Surtax" Overview

Example 4

Peter & Paula

- Married, filing jointly
- $400,000 salary income
- $50,000 net investment income

3.8% Surtax would apply to $50,000

Tax = $1,900

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3.8% Medicare "Surtax" Overview

Example 5

Sarah & Scott

- Married, filing jointly
- $200,000 salary income
- $150,000 net investment income

Excess of

MAGI	**$350,000**
Threshold	**- $250,000**
	=$100,000

3.8% Surtax would apply to $100,000

Tax = $3,800

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3.8% Medicare “Surtax” Overview

Example 6

Randy – Age 70

- Single taxpayer
- $200,000 investment income
- $125,000 RMD from his IRA

Excess of	
MAGI	**$325,000**
Threshold	**- $200,000**
	=$125,000

3.8% Surtax would apply to $125,000

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Recap: Powerful Income Tax and Surtax Reduction Opportunities

1. Master Limited Partnerships
2. Qualified Dividends
3. Return of Capital dividends
4. Low-turnover investment strategies
5. Real Estate & Leveraged Real Estate
6. **Life Insurance Strategies**
7. **Tax-Deferred Annuity Strategies**

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Recap: Powerful Income Tax and Surtax Reduction Opportunities

8. **Charitable Lead Trusts (non grantor trusts)**
9. **Charitable Remainder Trusts (smoothing strategy)**
10. **Charitable Remainder Retirement Trusts**
11. **"Income Shifting" CRTs**
12. **"Income Shifting" Family Trusts**
13. IRAs, Non-deductible IRAs, Roth IRAs
14. Profit sharing plans
15. Defined Benefit plans
16. Tax-exempt bonds

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Overview

- Why retirement distribution planning is important
- Income taxation basics of retirement investments
- Roth IRAs
- Tax-sensitive withdrawal strategies

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Why Retirement Distribution Planning is Important

Qualified Retirement Account vs. Non-Qualified Account Distributions

Perhaps one of the most important decisions a retiree must make is to determine from which retirement assets to withdraw funds to meet everyday living expenses.

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Why Retirement Distribution Planning is Important

Qualified Retirement Account vs. Non-Qualified Account Distributions

Key decision factors

- Size of accounts
- Investment mix / performance
- Marginal income tax bracket
- Time horizon

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Why Retirement Distribution Planning is Important

Qualified Retirement Account vs. Non-Qualified Account Distributions

OPTION 1 - Withdraw 100% From IRA

		2012	2013	2014	2015	2016
Husband's Age		64	65	66	67	68
Wife's Age		59	60	61	62	63
ASSETS		**2012**	**2013**	**2014**	**2015**	**2016**
IRA						
Beginning Balance		$ 1,300,000	$ 1,216,000	$ 1,127,620	$ 1,034,553	$ 936,472
Income	7.00%	91,000	85,120	78,933	72,419	65,553
Distributions		(175,000)	(173,500)	(172,000)	(170,500)	(169,000)
Ending Balance		$ 1,216,000	$ 1,127,620	$ 1,034,553	$ 936,472	$ 833,025
Brokerage Account						
Beginning Balance		$ 1,400,000	$ 1,474,010	$ 1,551,707	$ 1,633,325	$ 1,719,113
Yield (Interest & Dividends)	2.00%	28,000	29,480	31,034	32,667	34,382
Growth	5.00%	70,000	73,701	77,585	81,666	85,956
Subtotal		$ 1,498,000	$ 1,577,191	$ 1,660,327	$ 1,747,658	$ 1,839,451
Yield Disributed		(28,000)	(29,480)	(31,034)	(32,667)	(34,382)
Stock Sales		-	-	-	-	-
Net Cash Flow Reinvested		4,010	3,997	4,033	4,122	4,266
Ending Balance		$ 1,474,010	$ 1,551,707	$ 1,633,325	$ 1,719,113	$ 1,809,335
Total Assets		**$ 2,690,010**	**$ 2,679,327**	**$ 2,667,879**	**$ 2,655,585**	**$ 2,642,360**
CASH FLOW		**2012**	**2013**	**2014**	**2015**	**2016**
IRA Distribution		$ 175,000	$ 173,500	$ 172,000	$ 170,500	$ 169,000
Interest & Dividends		28,000	29,480	31,034	32,667	34,382
Stock Sales Proceeds		-	-	-	-	-
Subtotal		$ 203,000	$ 202,980	$ 203,034	$ 203,167	$ 203,382
Less: Income Tax		(66,990)	(66,983)	(67,001)	(67,045)	(67,116)
Less: Living Expenses		(132,000)	(132,000)	(132,000)	(132,000)	(132,000)
Net Cash Flow		**$ 4,010**	**$ 3,997**	**$ 4,033**	**$ 4,122**	**$ 4,266**

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Why Retirement Distribution Planning is Important

Qualified Retirement Account vs. Non-Qualified Account Distributions

OPTION 2 - Withdraw 100% From Brokerage Account

Husband's Age		64	65	66	67	68
Wife's Age		59	60	61	62	63
ASSETS		**2012**	**2013**	**2014**	**2015**	**2016**
IRA						
Beginning Balance		$ 1,300,000	$ 1,391,000	$ 1,488,370	$ 1,592,556	$ 1,704,035
Income	7.00%	91,000	97,370	104,186	111,479	119,282
Distributions		-	-	-	-	-
Ending Balance		$ 1,391,000	$ 1,488,370	$ 1,592,556	$ 1,704,035	$ 1,823,317
Brokerage Account						
Beginning Balance		$ 1,400,000	$ 1,344,910	$ 1,285,459	$ 1,221,390	$ 1,152,431
Yield (Interest & Dividends)	2.00%	28,000	26,898	25,709	24,428	23,049
Growth	5.00%	70,000	67,245	64,273	61,070	57,622
Subtotal		$ 1,498,000	$ 1,439,053	$ 1,375,441	$ 1,306,887	$ 1,233,101
Yield Disributed		(28,000)	(26,898)	(25,709)	(24,428)	(23,049)
Stock Sales		(130,000)	(131,500)	(133,000)	(134,500)	(136,000)
Net Cash Flow Reinvested		4,910	4,803	4,659	4,472	4,238
Ending Balance		$ 1,344,910	$ 1,285,459	$ 1,221,390	$ 1,152,431	$ 1,078,291
Total Assets		**$ 2,735,910**	**$ 2,773,829**	**$ 2,813,946**	**$ 2,856,466**	**$ 2,901,608**
CASH FLOW		**2012**	**2013**	**2014**	**2015**	**2016**
IRA Distribution		$ -	$ -	$ -	$ -	$ -
Interest & Dividends		28,000	26,898	25,709	24,428	23,049
Stock Sales Proceeds		130,000	131,500	133,000	134,500	136,000
Subtotal		$ 158,000	$ 158,398	$ 158,709	$ 158,928	$ 159,049
Less: Income Tax		(21,090)	(21,595)	(22,051)	(22,456)	(22,810)
Less: Living Expenses		(132,000)	(132,000)	(132,000)	(132,000)	(132,000)
Net Cash Flow		**$ 4,910**	**$ 4,803**	**$ 4,659**	**$ 4,472**	**$ 4,238**

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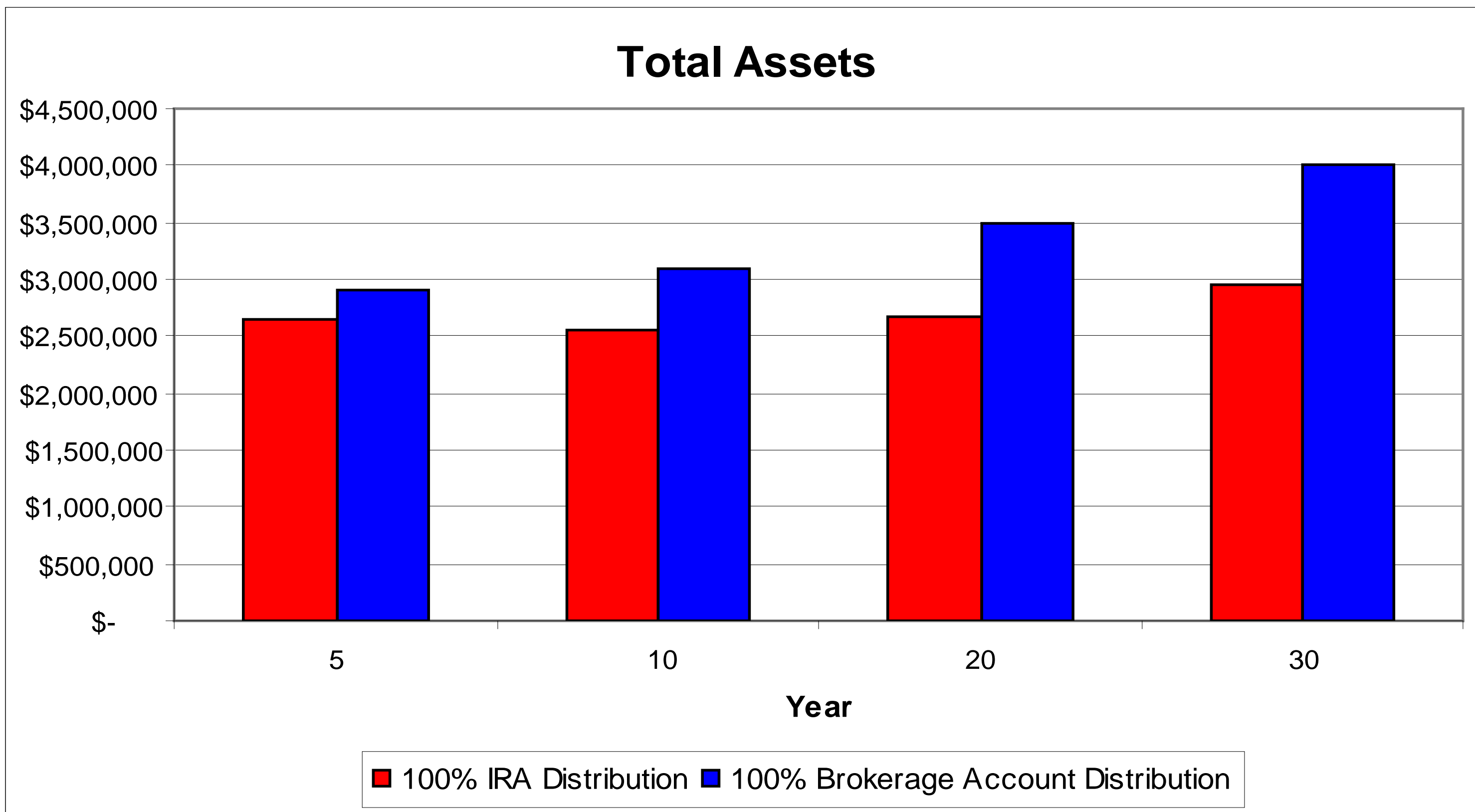
Why Retirement Distribution Planning is Important

Qualified Retirement Account vs. Non-Qualified Account Distributions



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Income Taxation Basics of Retirement Investments

Main Issues

- Understanding the main types of retirement investment accounts
- Understanding the main types of retired taxpayers
- Understanding current and future income tax rates
- Understanding impact of new 3.8% Medicare "surtax"
- Understanding the basic taxation principles of traditional IRAs (and other traditional qualified retirement accounts)

1040 U.S. Individual Income Tax Return 2010

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Income Taxation Basics of Retirement Investments

Three Main Types of Retirement Investment Accounts

- *Taxable investment accounts* – income generated within the account (i.e. interest, dividends, capital gains, etc.) are taxed each year to the account owner
- *Tax-deferred investment accounts (e.g. traditional IRAs, traditional qualified retirement plans, non-qualified annuities)* – income generated within the account is **not taxed** until distributions are taken from the account
- *Tax-free investment accounts (e.g. Roth IRAs, life insurance)* – income generated within the account is **never taxed** when distributions are made (provided certain qualifications are met)

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Income Taxation Basics of Retirement Investments

Main Types of Retired Taxpayers

- *Low income taxpayers* – taxpayers who generally are in the lowest income tax brackets (i.e. 10%, 15%) and are generally eligible for various income tax credits. Further, these taxpayers are usually in situations where their Social Security is not taxed
- *Low/middle income taxpayers* – taxpayers who are generally in the middle income tax brackets (i.e. 15%, 25% 28%) and are generally eligible for certain favorable tax attributes (e.g. 0% tax rate on capital gains/qualified dividends)
- *Middle/high income taxpayers* – taxpayers who are generally in the upper end of the middle income tax brackets (i.e. 28%, 33%) who oftentimes are subject to the Alternative Minimum Tax (AMT) and other phase-outs
- *High income taxpayers* – taxpayers who are in the highest marginal income tax bracket (35%) and are subject to several phase-outs and or "surtaxes" (such as AMT)

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Income Taxation Basics of Retirement Investments

- 2013 Ordinary Income Rates

	Single	Married Filing Jointly	Married Filing Separately	Head of Household
10% Tax Rate	$8,925	$17,850	$8,925	$12,750
15% Tax Rate	$36,250	$72,500	$36,250	$48,600
25% Tax Rate	$87,850	$146,400	$73,200	$125,450
28% Tax Rate	$183,250	$223,050	$111,525	$203,150
33% Tax Rate	$398,350	$398,350	$199,175	$398,350
35% Tax Rate	$400,000	$450,000	$225,000	$425,000
39.6% Tax Rate	> $400,000	> $450,000	> $225,000	> $425,000

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Income Taxation Basics of Retirement Investments

New 3.8% Medicare "Surtax"

Beginning with the 2013 tax year, a new 3.8% Medicare "surtax" on net investment income will apply to all taxpayers whose income exceeds a certain "threshold amount". This new "surtax" will, in essence, raise the marginal income tax rate for affected taxpayers.

- Thus, a taxpayer in the 39.6% tax bracket (i.e. the highest marginal income tax rate in 2013) would have a federal marginal rate of 43.4%!

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Income Taxation Basics of Retirement Investments

New 3.8% Medicare "Surtax"

Tax Rate in 2012	Tax Rate in 2013	Tax Rate in 2013+ (w/surtax)
10%	15%	15%
15%	15%	15%
25%	28%	28%
28%	31%	34.8%
33%	36%	39.8%
35%	39.6%	43.4%

NOTE: The chart above assumes that the 3.8% Medicare surtax would not begin to apply until a person's taxable income reaches the 31% tax bracket (based on certain net investment income and itemized deduction assumptions). However, there are times, though unlikely, when the 3.8% could apply to a person in a lower tax bracket (i.e. 15%, 28%) or may not apply to a person in higher tax brackets (31%, 36%, 39.6%).

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Income Taxation Basics of Retirement Investments

Taxation of IRAs

- To the extent that an IRA has only deductible contributions (plus income and growth), 100% of each IRA distribution will be subject to income tax in the year of distribution
- To the extent that an IRA has non-deductible contributions, a portion of each IRA distribution will not be subject to tax

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Income Taxation Basics of Retirement Investments

Taxation of IRAs

- When an IRA has non-deductible contributions, a portion of each IRA distribution will be a return of non-taxable "basis" to the IRA owner
- In determining the non-taxable portion of an IRA distribution, all IRAs and IRA distributions during the year (including outstanding rollovers) must be combined for apportioning "basis"
  - See IRS Form 8606

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Income Taxation Basics of Retirement Investments

Taxation of IRAs – Required Minimum Distributions (RMDs)

- Required Beginning Date: generally, April 1st of year following year client turns age 70½
  - Uniform Lifetime Table
- Required Minimum Distribution (RMD) = Minimum that must be distributed in a given year
- RMDs are calculated based upon the aggregate prior year ending account balance divided by the applicable life expectancy factor
- RMDs need not be distributed from each Traditional IRA, but rather the total RMD may be taken from any one of the Traditional IRAs, provided that the total RMD is taken

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Roth IRAs

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Roth IRAs

Benefits of Roth IRAs

- Lowers overall taxable income long-term
- Tax-free compounding
- No RMDs at age 70½
- Tax-free withdrawals for beneficiaries*
- More effective funding of the "bypass trust"
- New 3.8% Medicare "surtax" planning

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Roth IRAs

Reasons for Converting to a Roth IRA

1) Taxpayers have special favorable tax attributes including charitable deduction carry-forwards, investment tax credits, net operating losses (NOLs), high basis non-deductible traditional IRAs, etc.

2) Suspension of the minimum distribution rules at age 70½ provides a considerable advantage to the Roth IRA holder.

3) Taxpayers benefit from paying income tax before estate tax (when a Roth IRA election is made) compared to the income tax deduction obtained when a traditional IRA is subject to estate tax.

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Roth IRAs

Reasons for Converting to a Roth IRA

4) Taxpayers who can pay the income tax on the IRA from non-IRA funds benefit greatly from the Roth IRA because of the ability to enjoy greater tax-free yields.

5) Taxpayers who need to use IRA assets to fund their Unified Credit bypass trust are well advised to consider making a Roth IRA election for that portion of their overall IRA funds.

6) Taxpayers making the Roth IRA election during their lifetime reduce their overall estate, thereby lowering the effect of higher estate tax rates.

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Roth IRAs

Reasons for Converting to a Roth IRA

7) Federal tax brackets are more favorable for married couples filing joint returns than for single individuals, Roth IRA distributions won't cause an increase in tax rates for the surviving spouse when one spouse is deceased because the distributions are tax-free.

8) Post-death distributions to beneficiaries are tax-free.

9) Tax rates are expected to increase in the near future.

10) The new 3.8% Medicare surtax.

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Roth IRAs

Mathematics of Roth IRA Conversions

- Critical decision factors
  - Tax rate differential (year of conversion vs. withdrawal years)
  - Use of "outside funds" to pay the income tax liability
  - Need for IRA funds to meet annual living expenses
  - Time horizon

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Roth IRAs

Mathematics of Roth IRA Conversions

The key to successful Roth IRA conversions is to keep as much of the conversion income as possible in the current marginal tax bracket

- However, there are times when it may make sense to convert more and go into higher tax brackets
- Need to take into consideration the new 3.8% Medicare "surtax"
- Need to take into consideration the impact of AMT

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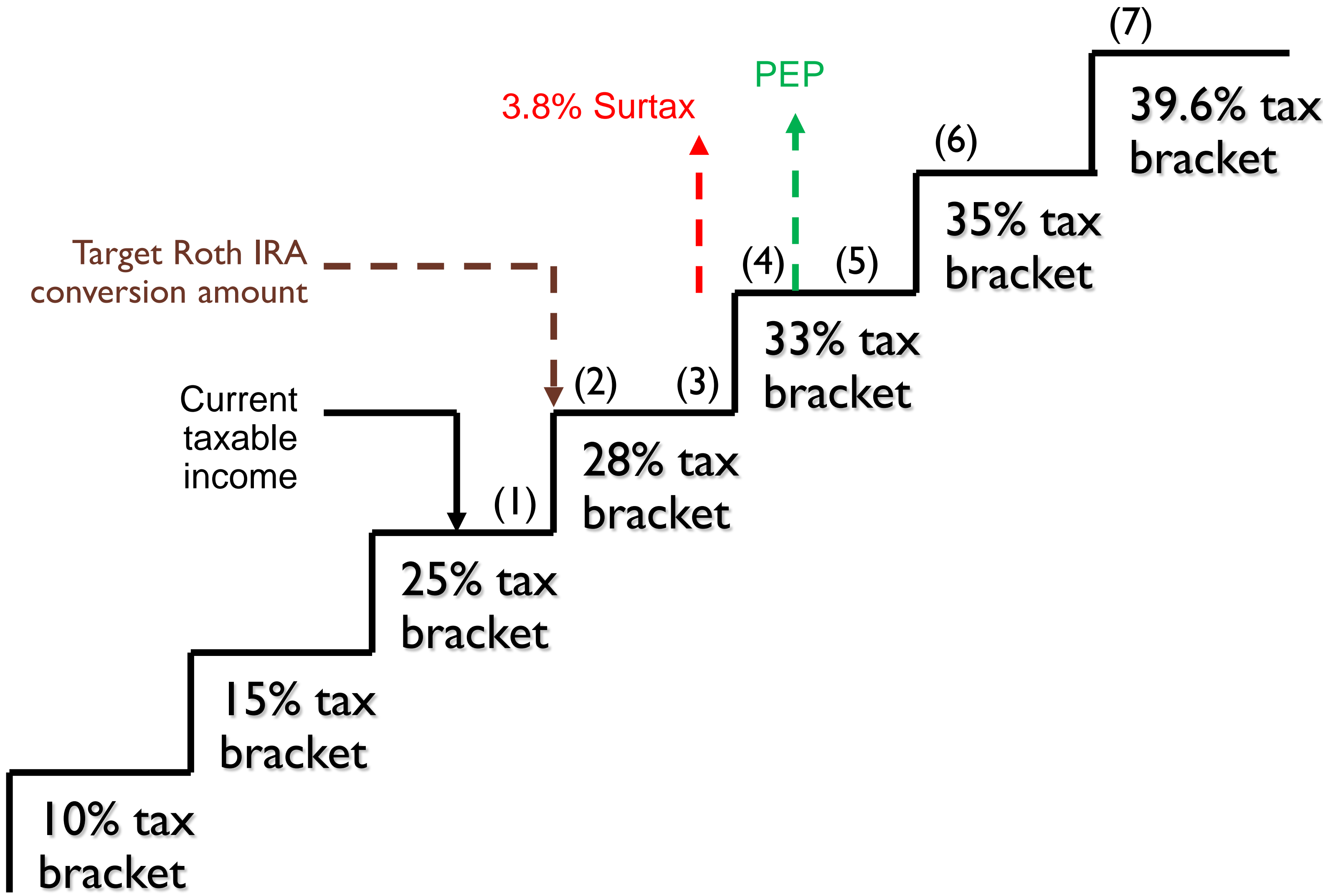
Roth IRA Conversions - Married



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Roth IRAs

Recharacterizations

- Taxpayers may "recharacterize" (i.e. undo) the Roth IRA conversion in current year or by the filing date of the current year's tax return
  - Recharacterization can take place as late as 10/15 in the year following the year of conversion
- Taxpayers may choose to "reconvert" their recharacterization
  - Reconversion may only take place at the later of the following two dates:
    - The tax year following the original conversion *OR*
    - 30 days after the recharacterization

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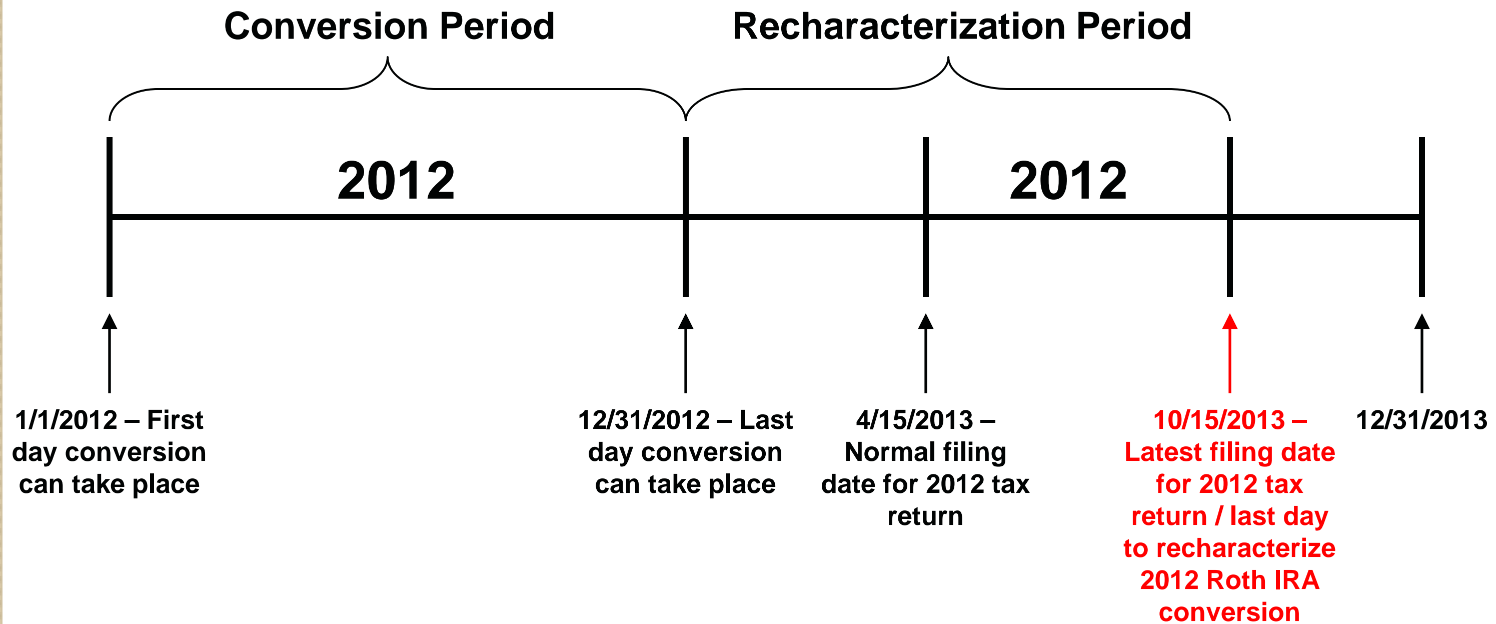
Roth IRAs

Recharacterization Timeline



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Tax-Sensitive Withdrawal Strategies

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Tax-Sensitive Withdrawal Strategies

- Managing capital gains and dividends
  - Short-term capital gains
    - Held 1 year or less
  - Long-term capital gains
    - Held more than 1 year
  - Taxpayers in the 10% & 15% tax bracket
    - 0% rate (2012)
  - Taxpayers in a tax bracket greater than 15%
    - 15% rate
    - 20% rate for taxpayers in the 39.6% bracket
  - Qualifying dividends
    - Taxed the same as capital gains

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Tax-Sensitive Withdrawal Strategies

- Manage taxation of Social Security benefits
- Manage income tax brackets
- Select high-basis securities to sell first
- Aggressively harvest outside portfolio losses
- Defer Roth IRA distributions
- Implement Roth conversions
- Manage charitable gifts
- 3.8% Medicare "surtax"

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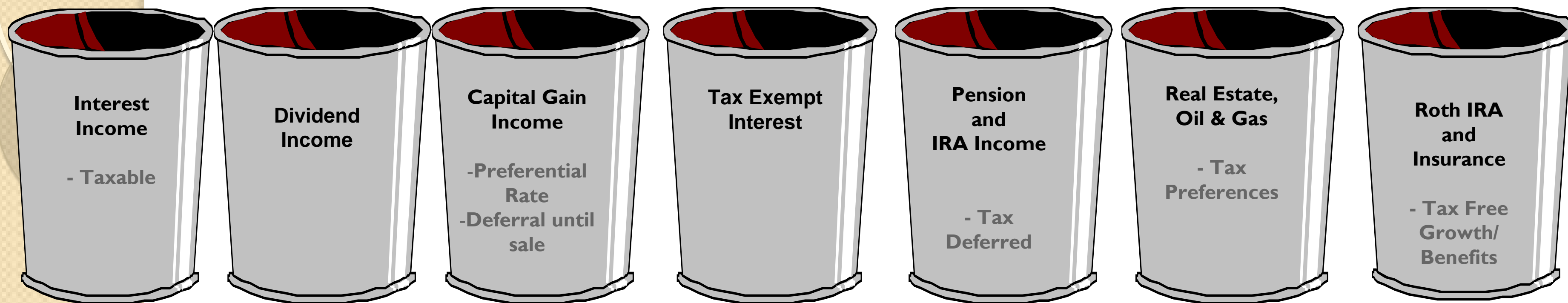
Tax-Sensitive Withdrawal Strategies



Interest Income

- Money market
- Corporate bonds
- US Treasury bonds

Attributes
- Annual income tax on interest
- Taxed at highest marginal rates

Dividend Income

- Equity securities

Attributes
- Qualified dividends at LTCG rate
- Return of capital dividend
- Capital gain dividends

Capital Gain Income

- Equity Securities

Attributes
- Deferral until sale
- Reduced capital gains rate
- Step-up basis at death

Tax Exempt Interest

- Bonds issued by State and local Governmental entities

Attributes
- Federal tax exempt
- State tax exempt

Pension and IRA Income

- Pension plans
- Profit sharing plans
- Annuities

Attributes
- Growth during lifetime
- RMD for IRA and qualified plans
- No step-up

Real Estate, Oil & Gas

Real Estate
- Depreciation tax shield
- 1031 exchanges
- Deferral on growth until sale

Oil & Gas
- Large up front IDC deductions
- Depletion allowances

Roth IRA and Insurance

Roth IRA
- Tax-free growth during lifetime
- No 70½ RMD
- Tax-free distributions out to beneficiaries life expectancy

Life Insurance
- Tax-deferred growth
- Tax-exempt payout at death

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Tax-Sensitive Withdrawal Strategies

Top Planning Ideas

1) Fill-up the 10% or 15% bracket
2) Roth conversions by asset class and Roth conversions to manage tax brackets
3) Spend from the outside portfolio first once you have "filled up" the 15% bracket
4) Bonds should generally be positioned in one's IRA because of the annual tax burden
5) Life insurance can be a very valuable supplement to existing pensions

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Tax-Sensitive Withdrawal Strategies

Early Accumulation Years (Ages 25-45)
Key Tax Concepts

- Maximize qualified retirement savings
- Maximize IRA accounts
- Position some funding in Roth IRAs or Roth 401(k)
- Deferral via annuities
- Low-risk Oil & Gas transactions
- Low-risk Real Estate transactions
- Focus on low-return strategies

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Tax-Sensitive Withdrawal Strategies

Core Accumulation Years (Ages 46 - Retirement) Key Concepts

- Continue to apply key concepts form early years
- Aggressively manage taxation of wage earnings
  - Retirement plans
  - Deferred compensation
- Aggressively manage taxation of investments

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Tax-Sensitive Withdrawal Strategies At Retirement - Key Concepts

- Evaluate rollover of pensions and profit sharing plan
- Evaluate asset protection issues
- Manage Net Unrealized Appreciation (NUA) opportunities
- Monitor the 10% IRC §72(t) penalty
- Manage basis in both IRAs and qualified plans
- Manage qualified Roth Distributions

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Tax-Sensitive Withdrawal Strategies

Early Retirement Years (Retirement to Age 70)
Key Concepts

- Manage the 10% and 15% tax brackets
- Generally defer IRA distributions taxed at 25% or greater
- Draw upon "outside" assets and deferred compensation first
- Draw upon traditional IRA assets second
- Draw upon Roth IRA assets last
- Review Roth conversions to manage tax brackets

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Tax-Sensitive Withdrawal Strategies

Later Retirement Years (After Age 70)
Key Concepts

- Manage the 10% and 15% tax brackets
- Take all Required Minimum Distributions (RMDs)
- Spend down high basis outside assets
- Draw additional funds from IRA to manage tax brackets
- Update estate planning

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Tax-Sensitive Withdrawal Strategies

- Consider the tax structure of the account as you allocate assets
  - Income producing assets in traditional IRA
  - Capital gains assets (especially those you intend to hold for a long period) in a taxable account
  - Roth IRA Rapid Growth

The illustration is NOT intended to be a recommendation, but to provoke thought. As you know, asset allocation should be determined according to risk tolerance and time horizon. Tax sensitivity would be considered secondarily.

	Bonds	Stock
IRA $500,000	$250,000	$250,000
Taxable Account $500,000	$250,000	$250,000

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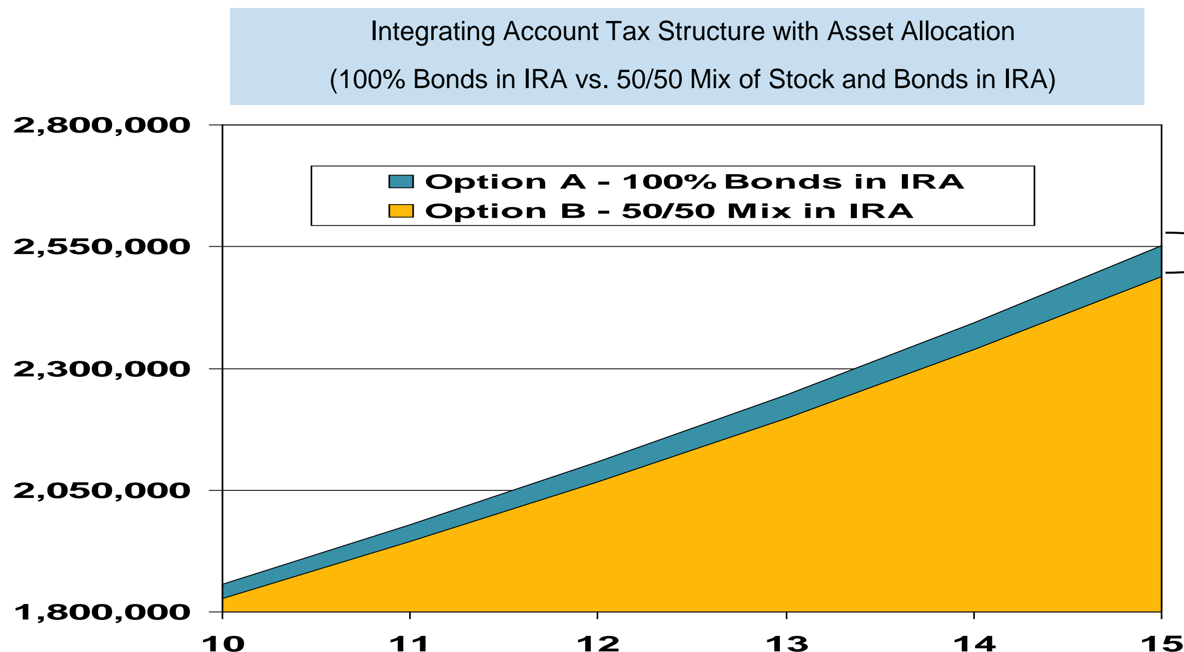
Tax-Sensitive Account Allocation

- Orange = position the investor would be at under the original 50% stock / 50% bond investment mix
- Blue = additional $63,890 of additional growth the investor would achieve by placing 100% bonds in IRA
- **Assumptions:** Bonds and the stock both generate a 7% return on a pre-tax basis. The stock earnings are deferred until the time of sale, then taxed as long-term capital gains. The amount of any tax savings from a deductible IRA contribution is invested in a taxable investment account earning the same yield as the IRA. The values shown for the IRA include the value of the taxable investment account. The client is in the 25% ordinary income tax bracket (15%* for capital gains purposes)



$63,890 of additional assets (2.6% increase)

* The 15% long-term capital gain rate is only effective under current law through 2010. It is not certain that the Congress will extend the 15% rate.

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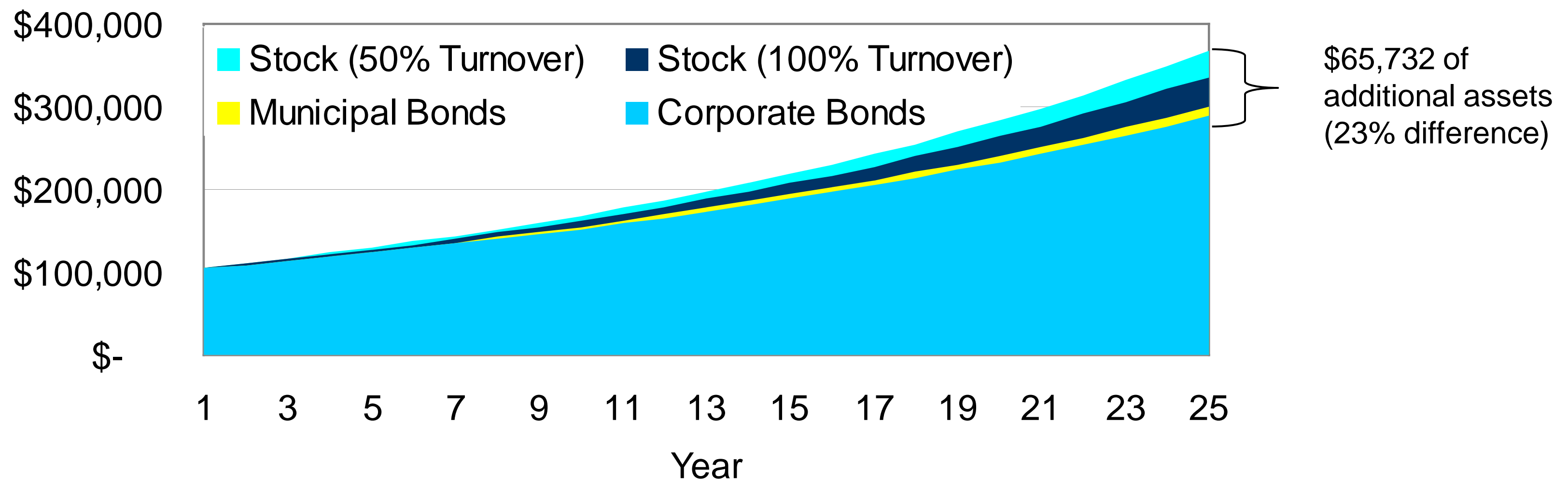
Effect of Capital Gains Incentives

- Example:
  - $100,000 beginning cash to invest and 28% tax bracket (15% long-term capital gains bracket)
  - Options:
    - Corporate bonds (6% annual interest)
    - Municipal bonds** (4.5% annual interest)
    - Stocks (1% annual non-qualified dividends, 5% growth [100% asset turnover])



•Effective in 2013, Congress has extended the 15% rate for people up to the new 39.6% tax rate.

•**Municipal bonds may not be suitable for a person in this low of a tax bracket.

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Tax-Sensitive Distribution Strategies

- Importance of a solid distribution strategy
- Four key issues to consider when structuring a distribution portfolio:
  - Which retirement investment vehicles (tax-sensitive account allocation) to include in the distribution portfolio
  - The order in which plan assets should be withdrawn
  - Loss harvesting and the specific identification method
  - Tactical income tax planning with defined benefit plans, tax-deferred annuities, Net Unrealized Appreciation, and Roth conversions

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Tax-Sensitive Distribution Strategies

- Timing is Everything – which tax-sensitive account should be used first
- Best result comes from withdrawing funds in a manner that produces the most favorable overall income tax consequences. (Be sure to consider heirs' income tax brackets)
- Some general (simplistic) concepts to consider – remember every client is different
  - Utilize taxable accounts first
  - Sell high basis assets first
  - Utilize IRA to manage tax brackets
  - Defer Roth IRA distributions
  - Carefully implement Roth conversions

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Tax-Sensitive Distribution Strategies

- Principle #1: Determining which tax-favored account to withdraw from first
  - Deals with the timing of withdrawals between tax-deferred assets (e.g. Traditional IRAs) and tax-free assets (e.g., Roth IRA)
  - Theory: If a retiree makes equal, after-tax withdrawals from tax-deferred and tax-exempt accounts, the order of the withdrawals between the two accounts will not affect the longevity of the withdrawal period of the two accounts
  - Assumptions: The assets in each account must both be growing tax-deferred at the same rate of return and the income tax rate must remain flat over the period of the analysis

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Tax-Sensitive Distribution Strategies

- **Principle #1 - Example 1:**

Assumes a 6% return	Traditional IRA First	Roth IRA First
Initial balance - Traditional IRA	$100,000	$100,000
Initial balance - Roth IRA	$100,000	$100,000
Federal income tax rate - Traditional IRA	28.00%	28.00%
Annual after-tax cash flow needed	$15,000	$15,000
Annual pre-tax withdrawal	**$20,833**	**$15,000**
Period until exhaustion - Initial asset	5.8	8.8
Period until exhaustion - Remaining asset	14.2	11.2
Maximum withdrawal period (years)	**20**	**20**

- No matter which account tax structure is depleted first, the maximum withdrawal period for both account tax structures is the same
- Assumes a 6% annual beginning of period return; a simple 28% tax rate; and distributions are sufficient to cover any RMDs.

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Tax-Sensitive Distribution Strategies

- **Principle #1 - Example 2:**

	100% Traditional IRA First	50/50 Mix
Initial balance - Traditional IRA	$100,000	$100,000
Initial balance - Roth IRA	$100,000	$100,000
Annual after-tax cash flow needed	$15,000	$15,000
Annual pre-tax withdrawal – Traditional IRA (15% tax rate)	$8,824	$8,824
Annual pre-tax withdrawal – Traditional IRA (28% tax rate)	$10,417	-
Annual pre-tax withdrawal – Roth IRA	-	$7,500
Annual pre-tax withdrawal (First 6 years comparison)	$19,241	$16,324
Period until exhaustion – initial asset	6.4	19.6
Period until exhaustion - Remaining asset	14.9	3.6
Maximum withdrawal period (years)	**21.3**	**23.3**

- By spreading out distributions over taxable & nontaxable accounts you may be able to keep your client in the marginal income bracket.
- Assumes a 6% annual beginning of period return; a simplified hypothetical marginal tax rate of 15% on the first $8,824 of income and 28% thereafter to achieve the 50/50 after-tax distribution mix; no other taxable income; and distributions are sufficient to cover any RMDs.

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Tax-Sensitive Distribution Strategies

- Principle #2: Things to consider when determining whether to withdraw from tax-favored versus taxable accounts
  - May be advisable to spend down taxable investment assets first followed by tax-deferred investment assets. But, consider the issue of large step-up in basis potential for elderly clients.
  - If client expects to be in the same or lower tax bracket than beneficiaries, consider client bearing a portion of the tax at their lower rate.

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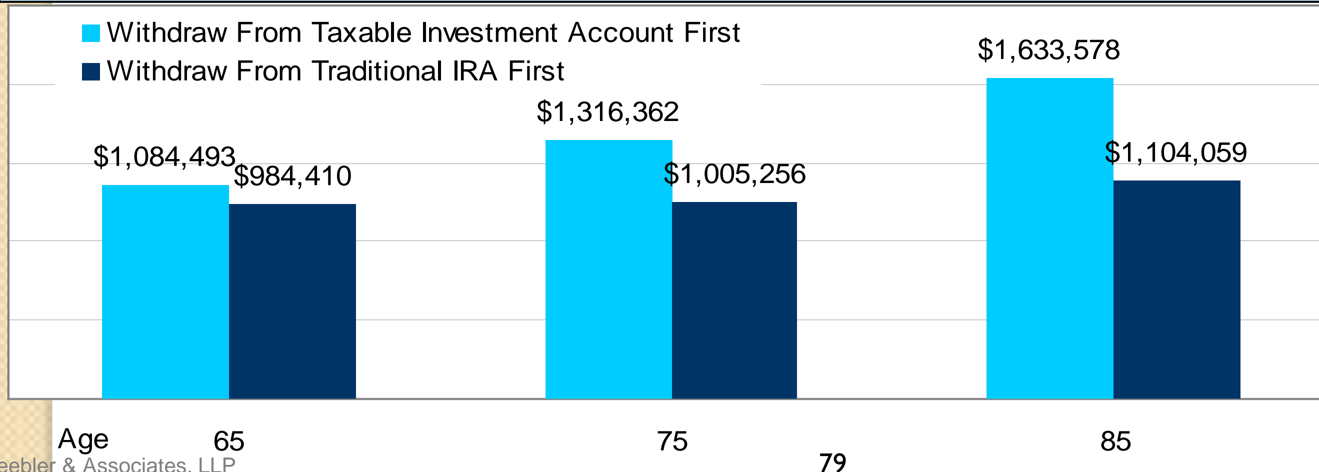
Tax-Sensitive Distribution Strategies

- Principle #2 – Example: Client, age 60 and single, has a $500,000 taxable account and a $500,000 Traditional IRA
  - Needs $60,000 annually for living expenses
  - Receives $12,000 of Social Security beginning at age 62
- **Assumptions:** Annual return consists of 3% ordinary income (i.e. interest income) and 4% growth on the value in each account. The stock earnings are tax deferred until the time of sale, then taxed as long-term capital gains. Basis on the sale is determined as a percentage of the total account value. Required Minimum Distribution (RMD) begins at age 70½, regardless of the intended distribution ordering. If the RMD and the income from the taxable account exceed the living expenses for a year, the excess is reinvested in the taxable account. 25% ordinary income tax rate, 15% capital gains tax rate, 85% of Social Security benefits are subject to income tax



$529,519 of additional assets (48% difference)

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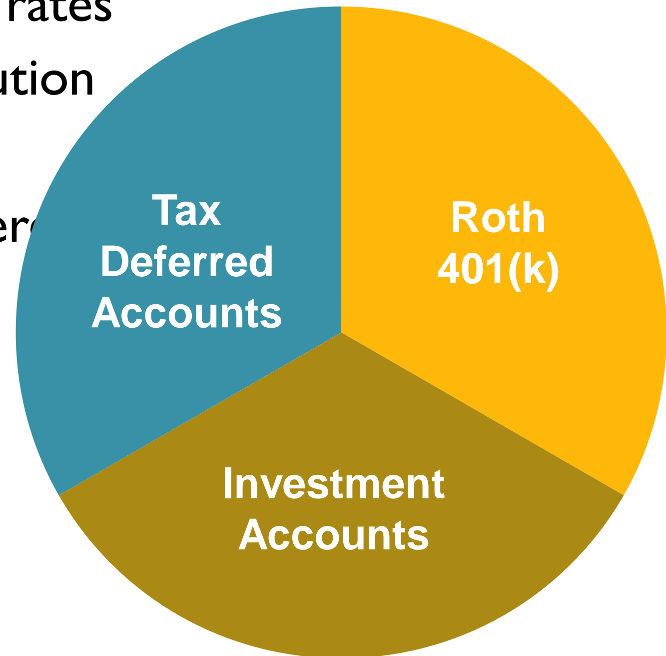
Tax-Sensitive Distribution Strategies In Theory

- Other considerations: future tax rates
- Some general (simplistic) distribution order to consider
  - Remember every client is differe
  - Taxable investments
  - Traditional IRAs and qualified retirement plans
  - Roth IRAs and Roth 401(k)s



Discuss with tax advisor prior to having elderly clients sell assets that could have received a step-up in basis

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Tax-Sensitive Distribution Decision Matrix

- Spend-down strategy should be structured in a way so as to maximize economic returns while minimizing income taxes
- Factors to consider
  - Investment returns within each account tax structure
  - Current and projected future income tax rates
  - Taxability of Social Security
  - Required Minimum Distributions
  - Long-term strategic goals
- Decision matrix:

Future income at the same or lower tax rate	**Future income taxed at higher tax rate**
1) Taxable account 2) Tax-deferred account 3) Tax-free account	1) Tax-deferred account 2) Taxable account 3) Tax-free account

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Loss Harvesting and the
Specific Identification Method

- Loss harvesting, especially in volatile markets, will often have a meaningful impact on the effective capital gains tax rate
- The truly sophisticated financial advisor will also integrate the benefits of the specific identification method when selecting which particular mutual funds (provided average cost has previously not been used on the account) or securities to sell

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Tactical Income Tax Planning

- Defined Benefit Plans
  - Distributions from a defined benefit plan will almost always generate ordinary income in the year received
  - There is a greater need for tactical tax-sensitive asset allocation planning when defined benefit plans are part of the retirement distribution equation

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Tactical Income Tax Planning

- Non-Qualified Tax-Deferred Annuities
  - Provides a client with the right to receive annual (or more frequent) payments over his life or for a guaranteed number of years
  - Unless a tax-deferred annuity is annuitized, the taxpayer is generally deemed to withdraw ordinary income first and then tax-free basis. This income tax consequence may be mitigated
  - One might purchase these investments in different tax years and then annuitize them over a period of years

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Tactical Income Tax Planning

- Employer securities in a qualified plan (Net Unrealized Appreciation)
  - Difference between Fair Market Value at distribution and basis is Net Unrealized Appreciation (NUA)
  - NUA is currently taxed at long-term capital gain tax rates (currently 5% / 15%)
  - Example:
    - Fair Market Value of stock $ 750,000
    - Employer basis $ 150,000
    - Net Unrealized Appreciation (NUA) $ 600,000
    - Amount taxable as ordinary income if stock is distributed and not sold $150,000

Distribution must qualify as a lump sum distribution employer stock be a “qualified employer security”
10% penalty may apply on the basis based on individual’s age

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Tactical Income Tax Planning

- Qualified Plan Rollovers
  - When rolling funds from a qualified plan to an IRA one has a choice of rolling over or not rolling over after-tax funds (i.e., basis)
  - Strong consideration should be given to not rolling over after-tax funds and utilizing these proceeds to fund a Roth conversion or spend on a tax-free basis

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Help Your Clients Go the Distance

- Work collaboratively with your client's other advisors to determine the best course of action
- Preparing for retirement is a life-long activity
- You can make a true difference in the financial lives of your clients!

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