Milestone Financial Planning, Inc.
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Stay Focused On The Need For Tax-Aware Investing

You already know that it's the amount of money you keep, as opposed to the amount you earn, that matters in the end. Even more than any fees you may be required to pay, the biggest drag on investment earnings is usually taxes. And taxes may come in many forms, ranging from tax on ordinary income to capital gains tax to the 3.8% surtax on "net investment income" (NII)—and that doesn't include any state and local taxes.

To minimize the strain, reassess your portfolio so that it emphasizes "tax awareness." That could mean focusing on what investments you own as well as where you hold them, in tax-deferred or taxable accounts. For instance, it doesn't make sense to load up on tax-free municipal bonds in a tax-deferred IRA that essentially wastes munis' special status. But an IRA could be a good place to hold other bonds or dividend-paying stocks which generate annual income that might otherwise add to your tax bill.

If you wonder how much tax-aware investing can really help, take a look at the attached chart. For simplicity, we'll assume that someone invests $10,000 a year for 40 years and generates an 8% pre-tax rate of return. The final value shows a high of more than $2.5 million for a "boring" person who stays the course and effectively realizes a 0% tax rate as compared to a low of less than $1 million for an "exciting" trader who buys and sells assets frequently and ends up with a 50% tax rate. The numbers don't lie.

Facing the Tax Obstacles

And what about the three types of taxes that may be generated in your taxable accounts? Here's a brief review:

Ordinary income: The top federal income tax rate on ordinary income is 39.6% (increased from 35% in 2013). Ordinary income rates apply to investment interest, short-term capital gains, and the taxable distributions from IRAs and workplace retirement plans.

Capital gains and dividends: Federal tax law provides preferential tax treatment for long-term capital gains on assets held longer than one year and for most dividends. While most taxpayers benefit from a maximum 15% rate (those in the two

(Continued on page 4)

Tax Aware Investing

Example

- *Example:* Depending on the tax rate, the accumulation of investing $10,000/year for 40 years at an 8% pretax rate of return will differ dramatically:

Tax Rate	After-Tax Growth Rate*	Final Value
0%	8.0%	$2,590,656
10%	7.2%	$2,102,199
20%	6.4%	$1,712,216
30%	5.6%	$1,400,380
40%	4.8%	$1,150,637
50%	4.0%	$950,255

*After-tax growth rate = 8% x (1-tax rate)

Results From Financial Calculators Don't Always Add Up

These days, you can find out virtually anything online. You no longer have to worry about "doing the math" on complex financial calculations. If you want to know how much interest you'll earn on an investment over a specified period or project how much you'll need to squirrel away for retirement, there's an app for that online. But be aware that these calculator apps aren't foolproof, as illustrated by the following real-life situation.

Someone just two years from retirement used an online calculator employing "Monte Carlo simulation," which tests many different variables to calculate the odds of funding your retirement successfully. In this case, one app based on an aggressive investment approach weighted heavily toward stocks revealed a 94% chance of achieving retirement goals. A second app, which used a more conservative allocation emphasizing bonds, indicated exactly the same 94% success rate. How could that be? It had to do with the way the app was programmed.

Don't assume that just because a calculator is online, it will provide you with the right answer. These apps can be black boxes, providing answers based on assumptions you can't check. When it comes to finance, you need answers you can trust. While online tools may be slick, having a professional calculate the numbers is best in all but the simplest situations. We're here to help.

IRA Rollovers: When Once Is Enough

Tax laws let you roll over money from one traditional IRA to another without owing taxes as long as you follow the rules and get it done quickly enough. But there is one restriction you might not know about: IRA-to-IRA rollovers generally are allowed only once a year, and a new court ruling says this once-a-year rule applies to *all* of your IRAs and not just a particular account.

This decision runs counter to what most tax experts believe. The IRS itself has interpreted the rule differently in its own publication on rollovers. Yet the Tax Court decided firmly against the taxpayer in the new case (Bobrow, T.C. Memo 2014-21).

In most cases, you won't be taxed if you transfer funds from one IRA to another as long as the rollover is completed within 60 days. (If the money isn't moved directly between trustees, income tax will be withheld and you'll have to recoup it on your tax return). That effectively gives you interest-free use of the funds for almost two months.

But there's one fly in the ointment. According to the plain language of the tax law, a taxpayer may roll over funds from one IRA to another IRA only once a year. The Tax Court applied this rule to all of a taxpayer's IRAs in the new case.

In this case, a taxpayer in 2008 received a distribution from traditional IRA #1 on April 14 and then took money out of IRA #2 on June 6. He repaid the required amount into IRA #1 on June 10 and did the same for IRA #2 on August 4. Because both repayments were made within the 60-day "window" for IRA rollovers, the taxpayer believed each rollover qualified for tax-free treatment. Therefore, he did not report any tax liability for IRS rollovers on his 2008 tax return.

However, the Tax Court said the once-a-year limit on IRA rollovers invalidated the transfer to IRA #2, causing that second distribution to be taxable. Based on its reading of the law and legislative intent, the court determined that the rule applies to all of a taxpayer's IRA accounts. "Regardless of how many IRAs he or she maintains, a taxpayer may make only one nontaxable rollover contribution within each one-year period," the court concluded.

That interpretation directly conflicts with guidance in Pub. 590, *Individual Retirement Accounts (IRAs)*. On page 25, the IRS provides an example with similar facts in which the once-a-year rule is applied to each IRA separately.

What happens now? As a follow-up, the IRS announced that it intends to follow the Tax Court ruling. Thus, it will likely pursue actions against other taxpayers who make multiple IRA rollovers in one year. As a result, it makes sense to stick to the strict letter of the law as defined by the court in the new case. ●

Don't Outlive Your Money: 7 Tips *By Bob McGinty*

The scariest financial risk people face in life is running out of money at an old age. I'm 83 and I'm speaking from personal experience. After a long career as a newspaper editor, I retired in 1991 at the age of 60, with my wife, who is 14 years younger and retired in 2004. I've learned about financial matters the hard way, and I ghost-write articles like this one to earn some extra income. I'm not scared about running out of money in my lifetime, but I am fearful of not leaving enough money to my wife, who is much younger than I. Let me share with you some financial lessons I've learned.

1. DO NOT elect to take Social Security benefits early. If you do take early benefits, you probably will be shortchanged on what you would have received in total payments over the rest of your lifetime. People are living longer these days. You will add 8% a year in payment totals after full retirement age if you can wait until age 70 to take benefits.

2. Downsize your home at the earliest opportunity. Once you become an empty nester, the odds are that you do not need a house as large as the one in which you now live. Sell it and buy a smaller one. Pay cash if at all possible.

3. Consider moving to a retirement community, which can be a highly desirable and cost-efficient place for the elderly to live. Your neighbors in such communities most likely are like-minded and in your age group. Also, such communities are especially designed for elderly living, and most are located near good health-care facilities. Plus, they offer social, educational and recreational facilities designed specifically for the elderly.

4. If you are not already out of debt, get out as soon as possible. When you are not in debt you can live on much less month to month, thereby lessening your chances of outliving your money.

5. If you have two cars, sell one. If you only have one, drive it twice as long

Entering The Twilight Zone—Of Taxation

Rod Serling, creator of the classic science-fiction TV series, "The Twilight Zone," could not have come up with a stranger tax structure. You have entered a five-dimensional tax zone, a tax labyrinth so strange it almost seems like science fiction.

There's more to the federal income tax system than just a single calculation. In fact, upper-income taxpayers—especially those generating income from investments—actually must cope with five "dimensions" of taxation: (1) ordinary income tax; (2) capital gains and losses; (3) the alternative minimum tax; (4) the net investment income tax; and (5) a reduction of itemized deductions and personal exemptions. Here's a quick rundown:

1. Ordinary income tax. This is the standard tax calculation we're all familiar with. The income you earn generally is taxed under a graduated rate structure with seven tax brackets: 10%; 15%; 25%; 28%; 33%; 35%; and 39.6%. If you're in the top tax bracket, any extra income you earn is taxed at the 39.6% rate. Tax deductions and credits can be used to offset your tax liability based on these ordinary income rates, but certain special rules may apply (see #5).

Furthermore, under the "kiddie tax," if investment income of a dependent child exceeds an annual threshold ($2,000 in 2014), the excess generally is taxed at the top tax rate of the parents. This can hike the overall family tax bill.

2. Capital gains and losses. The tax law provides separate tax treatment for capital assets such as securities and real estate. Generally, gains and losses from capital assets are used to offset each other. Long-term gains from assets held longer than a year qualify for a maximum 15% tax rate, but the rate increases to 20% for those in the top two ordinary income tax brackets. Qualified dividends also benefit from these preferential tax rates.

In addition, you can use excess capital losses to offset up to $3,000 of ordinary income, and you can carry additional losses over to next year. With that in mind, "harvesting" losses is a common year-end tax strategy.

3. Alternative minimum tax. The alternative minimum tax (AMT) runs on a track parallel to ordinary income tax. This complex calculation involves certain additions and adjustments before subtracting an exemption amount based on your tax filing status. However, the exemption is reduced for high-income earners. There are just two tax brackets—26% and 28%—for taxpayers with AMT liability.

At tax return time, you compare your ordinary income tax result to the AMT result and effectively pay the higher of the two. This "alternative" tax often catches unwary taxpayers by surprise.

4. Net investment income tax. The "net investment income" (NII) tax is a new wrinkle that taxpayers have to deal with for the 2013 tax year and beyond. You must pay a 3.8% Medicare surtax on the lesser of your NII or your modified adjusted gross income (MAGI) above an annual threshold—$200,000 for single filers and $250,000 for joint filers. For this purpose, NII is defined to include interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from passive activities, and income from the trading of financial instruments or commodities. But some items, including wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions from IRA and qualified retirement plans, are excluded from the definition.

The NII tax is an add-on to the ordinary income tax calculation. Thus, your combined top tax rate can be as high as 43.4%!

5. Reduction of itemized deductions and personal exemptions. Two tax law provisions that were reinstated in 2013 may affect upper-income taxpayers adversely. Under the "Pease rule" (named for the congressman who originated it), certain itemized deductions, including those for charitable donations, state income tax, and mortgage interest, are reduced if your adjusted gross income (AGI) exceeds an annual threshold. For 2014, the threshold is $254,200 of AGI for single filers and $305,050 for joint filers. The total of your itemized deductions covered by the Pease rule is reduced by 3% of the amount above the AGI threshold, but not by more than 80% overall.

A similar rule phases out the tax benefit of personal exemptions. Under the personal exemption phaseout (PEP) rule, exemptions are reduced by 2% for each $2,500 (or portion thereof) of your AGI that exceeds an annual threshold. The PEP thresholds are the same as those for the Pease rule.

Beyond these five, a sixth dimension exists for most taxpayers—state income taxes. ●

as you did in the past. You probably will be driving less at this time in your life, and you can most likely drive your current car much longer without encountering excessive repair bills. If you are in the practice of making monthly car payments, once you've paid off your vehicle you can put all of the payments you would have made before into your savings.

6. If you are part of a close-knit family, do not move very far from your children and grandchildren. Life-changing occurrences such as death, divorce and disabilities are easier experiences when you have the support of family members around you all the time.

7. Finally, and most important of all: Continue to save all that you possibly can. The amount that you can save if you follow the previous six recommendations may be considerable. Where and how should you invest it? Seek out a financial advisor that you are sure you can trust and that you are sure is competent, and turn investment decisions over to him or her. ●

Bob McGinty is a retired newspaper editor who occasionally ghost-writes articles for financial advisors.

Count On The Portability Provision

Though it's still true that you can't take it with you, a recent tax law change makes it easier to reduce or eliminate estate tax liability for your heirs. Thanks to a "portability" provision that's now part of the law, any unused portion of the individual exemption from federal estate tax that isn't used by the estate of the first spouse to die may be claimed by the surviving spouse's estate.

This special estate tax break, first enacted in 2010, was set to expire after 2012. However, the American Taxpayer Relief Act (ATRA) extended it for 2013 and thereafter. Barring drastic change, you can count on portability for the foreseeable future.

Under ATRA, the federal estate tax exemption is locked in at a generous $5 million that is increased annually to account for inflation. (The exemption for 2014 is $5.34 million.) As a result, a couple in 2014 can transfer up to $10.68 million without incurring a dime of federal estate tax.

Suppose a husband owns $4 million on his own, his wife has $3.5 million, and they hold $2.5 million in both their names—jointly with rights of survivorship, in legal jargon. Each spouse's will leaves his or her entire estate to the other spouse and, upon the death of that spouse, to the couple's children.

Now suppose that the husband dies first in 2014. Because all of his individually owned assets pass to his wife, his estate needn't use any part of his federal estate tax exemption. (Spouses normally can inherit an unlimited amount from each other without estate taxes.) So the wife now owns all of the couple's assets, worth a total of $10 million. When she dies, that $10 million in assets goes to the couple's children. Without portability, the wife would have only her own exemption, and that would leave her estate responsible for estate taxes on $4.66 million (the $10 million in assets minus her $5.34 million exemption). At the current 40% estate tax rate, the estate would owe more than $1.8 million—money that wouldn't go to the children. With portability, however, the combined exemption of $10.68 million more than covers the $10 million in the estate, and the heirs pay no estate tax.

As beneficial as the portability provision can be, it won't necessarily solve every potential estate-planning problem. For example, it still might be a good idea to establish a bypass trust, a tool that, before portability, could be used to maximize the estate tax exemptions of married couples. Although no longer needed for that purpose, a bypass trust still could be used to protect assets from creditors, guard against other tax consequences, such as the generation-skipping tax, and be especially helpful in allocating assets when one or more spouse has children from a previous marriage. ●

Stay Focused On The Need

(Continued from page 1)

lowest tax brackets pay 0%), the rate increases to 20% for upper-income investors in the highest tax bracket.

NII surtax: You now must pay a 3.8 % surtax on the lesser of NII or the amount of your modified adjusted gross income (MAGI) that exceeds the threshold of $200,000 for single filers and $250,000 for joint filers. This surtax is added to your regular income tax liability, so you might pay an effective top tax rate of 43.4% on ordinary income and 23.8% on long-term capital gains and qualified dividends.

7 Strategies for Tax-Aware Investing

Keeping these tax ramifications in mind, here are seven ways to fine-tune your portfolio:

1. Increase investments in tax-favored assets. Some obvious choices include tax-free municipal bonds as well as real estate, annuities, life insurance, and other tax-advantaged vehicles, just to name a few possibilities.

2. Defer capital gains. When possible, defer large gains to years in which your overall income may be lower, or try to spread your tax liability over several years. For example, you might accept installment payments when you sell real estate.

3. Change how your portfolio is put together. Design it to accommodate both current and future needs. Typically, you should emphasize both asset allocation and diversification of investments.

4. Consider your after-tax asset allocation. Remember that it's what you keep, not what you earn, that counts. Incorporate this principle into your mix of investments.

5. Develop a tax-sensitive asset allocation. Be aware of how taxes will affect your investments. For instance, factor in capital gains taxes and the 3.8% surtax on NII.

6. Manage your tax brackets from year to year. Do your best to stay below the thresholds for triggering a higher tax rate. Push income into low-tax years and pull income from high-tax years.

7. Manage capital gains holding periods. Remember that the preferential tax rates apply to gains from capital assets held longer than one year. ●

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