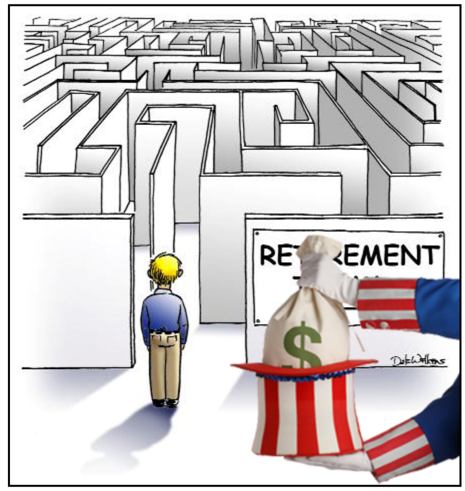
Are you getting "Tax Alpha"?

Navigating the Retirement Maze



"The only difference between death and taxes is that death doesn't get worse every time Congress meets."

– Will Rogers, American humorist (1879-1935)

"Investment alpha" is dead. Jason Zweig stated as much in his Wall Street Journal column last year entitled *"The Decline and Fall of Fund Managers."* Alpha refers to the amount by which professional investment managers exceed market performance due to skill rather than luck, and without taking on additional risk. Statistics developed annually by Standard & Poor's consistently shows that, after fees, very few investment managers can beat the market consistently. Charles Ellis, regarded as one of the deans of the investment management industry, said that "With rare exceptions, active management is no longer able to earn its keep."

Conversely, U.S. tax regulations are quite specific, and familiarity with these laws and an individual's income and asset situation can often yield tax savings which are predictable in a given tax year. If your financial advisor tells you that by making some asset changes and relocations, they can save you $8,000 on your taxes, then they've just achieved "tax alpha" for you. (On the other hand, if your advisor has no interest in tax savings and focuses only on your investment performance, maybe it's time to look for a new advisor.)

"Tax alpha" is real money

Securities markets are speculative and unpredictable. But there is nothing speculative about tax loss harvesting to offset gains, bracket management to reduce tax liabilities, and asset relocation to decrease future taxes. It's legitimate, it's predictable, and it produces real monetary returns.

As Will Rogers noted above, tax laws do change from time to time, but there is still an element of predictability to tax legislation, as Congress usually prefers not to upset their constituencies with abrupt changes. Thus, tax planning should be a critical part of your overall financial planning.

Manage your brackets

No, I'm not referring to the March Madness office betting pool. I'm talking about your current marginal tax rate, the amount of additional income that would bring you up to the next tax rate level, and your anticipated tax rate in retirement. The effectiveness of Roth IRA conversions, harvesting tax losses, realizing capital gains, and asset spend-down strategies depend largely upon where you are, tax bracket-wise, and where you anticipate you'll be. Have a lean income year? It could be an ideal time to consider a Roth conversion or taking some capital gains at a lower rate, being mindful to watch how these gains or conversions will move you closer to the next tax bracket. Fill up that lower bracket with gains at that lower rate, and save money compared to doing it in a higher income year.

Pay attention to the marginal tax rates of your adult children as well. Do your recent college grads need an economic boost from home? Don't give cash. Gift them appreciated assets instead. They can sell them and pay the capital gain at their much lower rate, 0 percent in many cases, saving you the 15 to 20 percent that you would have paid to sell the asset yourself. (Note: Beware of the "kiddie tax" in the years that they are in college, as gains above $2,000 are taxed at the parent's marginal rate.)

Location, location, location

Like real estate, asset location plays a key role in your tax liability. The rule of thumb is to keep income- and dividend-generating assets in tax-deferred or tax-free accounts, and growth assets in taxable accounts. Exchange traded funds (ETFs) can be a good choice for the latter category, as the vast majority rarely have capital gains until you sell the ETF, unlike traditional mutual funds where you can get stuck with a tax bill even if you're a "buy and hold" investor.

If you find that you have too many income-generating assets outside of tax-deferred accounts, there are ways to improve your tax situation. Low-cost annuities and whole life insurance policies can be good alternative to bonds, in that their income accrues tax-deferred, and you can choose policies where you can receive the payouts during your retirement years when your income (and tax rate) should be lower.

A key element of financial planning

Annual reviews of your tax and asset location situations should be a regular part of your financial planning regimen. There's real money to be saved by careful tax planning. Which would you prefer to hear from your advisor: That she might be able to achieve decent returns on your portfolio, or that she can definitely save you $12,000 in taxes this year? Pay attention to taxes, and you won't be paying Uncle Sam more than what he's due.

George Gagliardi is a fee-only full-service financial advisor with Coromandel Wealth Management in Lexington, where he helps clients develop and implement investment and retirement strategies. He can be reached at (781) 728-9001 or george@CoromandelWM.com. George is affiliated with Trust Advisory Group, Ltd., a Registered Investment Advisor. *This article is intended for general information purposes only, and may not be appropriate for your specific circumstances. Investment advice is particular to each individual, and should only be given after an individual situation has been reviewed.*