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COROMANDEL WEALTH MANAGEMENT

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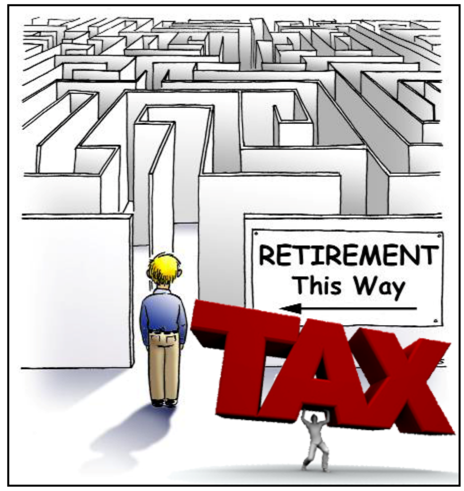
Taxing Times

Navigating the Retirement Maze



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

– Will Rogers

April 15th is just around the corner, and perhaps the only consolation is that this year's tax bite will most likely be less than in future years. Our government continues to spend money like a drunken sailor, the Federal Reserve prints more of it to spend, and Congress attempts to find ways to increase tax revenues without jeopardizing their electability. The American Taxpayer Relief Act of 2012 (ATRA) enacted this past New Year's Day hit the top "1%" particularly hard, though it did little to reduce our deficits. So expect to see more tax increases going forward.

A key part of financial planning is managing your investments to minimize your tax bill, both now and in retirement. I'll discuss some approaches that are applicable even to the 99% who dodged the ATRA tax bullet.

Tax Efficient Investing

While you shouldn't let tax considerations override your investment strategy, tax efficiency does determine how much of your gains you get to keep. The simplest rule is that gains should be held for at least a year to get the long-term gains rate, set by ATRA at 0%/15%/20% depending upon your income level. Otherwise, you'll pay the higher ordinary income tax rate. Mutual funds with low turnover rates are more efficient in this respect.

There are also specific investments that yield tax benefits. Muni bonds are the most commonly used ones, though they aren't without risks, including: rising interest rates, high markups by brokerage firms, and default. The higher your marginal tax rate, the greater the advantage these bonds offer. Beware of the AMT trap if your bonds aren't designated as "AMT-free."

The lower tax rates for qualified dividend income have been made permanent by ATRA, thus maintaining the appeal of dividend-paying stocks. Note that this does not include dividends from bonds, real estate investment trusts (REITs), or master limited partnerships (MLPs), all of which are considered "ordinary dividends" and taxed at your ordinary income tax rate. However, REITs and MLPs have other tax advantages. A portion of their income may be classified as "return of capital", "depletion", or "depreciation", which defer the taxes on part of the income until you sell the shares. The downside is dealing with those irritating K-1 tax forms, but tax software facilitates this task considerably.

If you find the need to shelter additional income, consider the tax advantages of annuities and cash-value life insurance. Do your homework, though, and make sure to pay careful attention to the fees and policy restrictions.

Location, Location, Location

It isn't just real estate where location is important, but also for tax efficiency of your investments. Conventional wisdom dictates that you should put your income generating assets – bonds, REITs, CDs – in tax-deferred accounts. This is because when you eventually start withdrawing funds from these accounts, you'll be taxed at your ordinary income rate, the same as if they had been in a taxable account but with the benefit of tax deferral.

However, the question you need to ask is: Will my marginal tax rate be higher when I'm retired than it is now? Typically, income during retirement is lower than in pre-retirement years. But tax rates almost certainly won't stay the same, so this involves some future rate and income guesswork on your part. Pick a few plausible scenarios, do the numbers, and allocate your assets accordingly.

Fill All Your "Tax Buckets"

Another piece of conventional wisdom is to put as many of your assets as possible in tax-deferred accounts, allowing your returns to compound tax-free until you withdraw them. However, this can create several problems during retirement. First, you'll wind up with higher RMDs at 70½, resulting in higher taxes and Medicare premiums. Second, you reduce the ability to manage your taxable income in retirement because most of your withdrawals for living expenses will be taxed.

Having a significant percentage of your assets in taxable accounts will allow you to draw from these and keep you from moving into a higher tax bracket. Not knowing what the tax code will look like when you retire implies that you should plan to have this flexibility. Consider using partial Roth IRA conversions over a number of years to fill your "already taxed" bucket.

Stay Vigilant

In its 100 years of existence, the IRS Tax Code has grown from 300 pages to over 70,000 pages. The only certainties in life? Death, taxes, and tax law changes. Be aware of how your investments are affected by these changes, and manage them accordingly.

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