INVESTMENTS & TAXES

POWERFUL PLANNING!

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When considering how to build one's wealth, experience a financially secure retirement, and possibly pass on some "excess wealth" to subsequent generations and/or charity, it really helps to fully understand the close connection between taxes, investments and your overall planning, and to have professional assistance at that intersection. Income taxes are usually the highest expense anyone has year to year, and the total amount of tax paid each year depends on the type of income generated – be it salary, interest, dividends, long and short term capital gains, as well as taking into consideration all of the various deductions available.

Different types of investments generate different kinds of income and it is important to understand at what rates each piece of income will be taxed. The goal, of course, is to minimize the amount of taxes being paid, while keeping as much income as possible, to help build wealth.

Making good investments will also help build wealth, but it is important to know how the returns on investments can be maximized after considering the taxes that will be levied on them. The decision of when to realize capital gains and losses is one area where coordinating investment considerations with the tax implications can be crucial. Long term capital gains are taxed at many different rates. Investors in the lowest two tax brackets actually pay a 0% rate on capital gains while investors in higher brackets pay either 15% or 20%. For those in the 20% bracket, the rate is actually 23.8% after factoring in the 3.8% Medicare surtax. The conventional wisdom among most advisors is to harvest capital losses before year end to offset any gains that an investor may have realized throughout the year. Because of the variety of rates that apply to long term capital gains, this is not always a good strategy. Without careful planning, you might

end up using losses to offset gains that would be taxed at 0% rather than saving them for a later year when they might offset gains being taxed as high as 23.8%!

Everyone knows that a person in a high tax bracket can benefit from an investment in tax free municipal bonds. Such bonds have slightly lower yields than taxable bonds of similar maturities, but after taking into account that no tax is owed on the interest from tax free bonds, they tend to produce a higher after-tax return than taxable bonds. However, tax exempt interest is added back to a taxpayer's Adjusted Gross Income for determining the level of Medicare Part B premiums. As income goes higher, so does the cost of Medicare. In some cases, just reducing tax exempt income by a small amount could save a person a disproportionate amount of premium cost.

Investors with IRA accounts must begin required minimum distributions ("RMDs") at age 70 ½. An increase in income at that age may cause them to pay a higher Medicare B premium, or possibly face higher tax rates at the time of distribution. In some cases, it may be beneficial to start taking distributions before age 70 ½ or to convert some of the traditional IRA to a Roth IRA. By spreading the income out over a greater number of years, they might end up paying a lower overall tax rate and will reduce the amount of RMDs needed to be taken later from the traditional IRA account. Minimizing taxable income is becoming more important as more benefits become income-tested, like Medicare B premiums.

Once people accumulate enough assets to achieve financial security during retirement, they may wish to plan to transfer assets to subsequent generations, or to charity. Gift taxes and estate taxes may come into play, and knowledge about the type of investments that can be gifted tax-efficiently, or how investments might be taxed in an estate and passed on to heirs, or possibly

distributed to charity, can make a big difference in the "net after tax" amount that can be passed on.

There are many other examples of instances where detailed knowledge of our tax system can have a profound effect on the "net return" on various investments. Many people use an accountant to prepare their tax returns, and another professional to advise them about their investments. In these cases, very little, if any, coordination takes place to ensure they obtain the best possible "after tax returns" on their investments. Utilizing an advisory firm that can provide detailed tax projections, while also considering and advising about various investments, greatly increases the opportunity to maximize wealth.

With the new administration in Washington, DC, we expect there will be some very drastic changes in the tax laws. There has been some discussion about the possibility of eliminating the Medicare tax of 3.8% on investment income, eliminating the AMT, lowering tax rates and raising the standard deduction while possibly eliminating some deductions. No doubt there will be a host of other changes in how taxes are calculated, which could have a big impact on how investment returns are taxed.

The new administration has also discussed the possibility of repealing the estate tax altogether. While this may sound like a windfall to those with greater wealth, these is also discussion about replacing the estate tax with a capital gains tax levied on assets which pass to beneficiaries. Details about how this tax may be structured and any exemption which might be part of the regime, are not known at this time. But keeping careful track of the tax basis for all of one's assets, whether marketable securities or direct investments in real estate or operating business, can pay dividends when planning to tackle these new rules.

As with any new rules, there will be opportunities to plan to minimize taxes. As a result, working with an advisory firm with a keen eye on the interplay between taxes and investments, and which can make appropriate recommendations under the circumstances, can make a big difference over time in how one builds wealth and continues to enjoy it.