Tax Strategies From a Financial Planning Perspective

spectrum
advisors

Spectrum Advisors

- *Don Goerner offers securities through Purshe Kaplan Sterling Investments Member FINRA/ SIPC Headquartered at 18 Corporate Woods Blvd., Albany, NY 12211*
- *Mike Reppert offers securities through Kalos Capital, Inc. 3780 Mansell Rd., Suite 150, Alpharetta, GA 30022(678) 356-1100*
- *Spectrum Advisors is not an affiliate or subsidiary of Kalos Capital, Inc.*
- *Investment Advisory Services offered through Spectrum Advisors, Inc., 15301 Spectrum Dr., Suite 115, Addison, TX 75001*
- *Spectrum Advisors is not an affiliate or subsidiary of Kalos Capital, Inc. or Purshe Kaplan Sterling Investments*

Tax-saving strategies

- **Converting to a Roth IRA**
- **Tax favored oil/gas investments**
- **Stretching the benefits of IRAs to beneficiaries**
- **Minimizing taxes through Net Unrealized Appreciation (NUA)**
- **72(t) distributions**
- **Tax-free treatment of IRA distributions to charity**

ROTH -IRA Conversion

Advantages of Roth IRA conversion

- **Federal income tax-free distributions**
  Distributions from a Roth IRA are tax free, provided the Roth IRA has met the five-year aging period and the holder is aged at least 59½, disabled, or deceased

- **Potentially greater value- 100% of growth is tax-exempt**
  Depending on certain factors, a Roth IRA may provide more income after taxes than a Traditional IRA

- **No required minimum distributions at age 70 1/2**
  RMDs on inherited Roth IRAs apply

Roth conversion eligibility requirements: For an individual or a married couple filing jointly, their modified adjusted gross income cannot exceed $100,000 in the year of conversion, excluding the amount being converted, and any required minimum distributions. Married individuals filing separately are not eligible to convert to a Roth IRA unless they lived apart for the entire year.

Roth IRA conversion

- Starting in 2010, the $100,000 Adjusted Gross Income (AGI) limitation no longer applies
  - The taxable income recognized on a Roth IRA conversion in 2010 may be spread over the following two tax years (i.e. 2011 and 2012)
- Married Filing Separately taxpayers can convert to a Roth IRA

Roth IRA conversion

- **Types of Roth IRA conversions**
  - **Rollover from a traditional IRA to a Roth IRA.**
    - The 60-day deadline applies.
  - **A direct transfer from the traditional IRA to the Roth IRA**
    - Trustee-to-trustee transfer
  - **A “ re-characterization” of an existing traditional IRA as a Roth IRA**

Roth IRA conversion

- The 5-year period for all of a participant's Roth IRAs begins on January 1 of the first year for which a contribution was made to <u>any</u> Roth IRA owned by that participant.
  - A surviving spouse gets to treat an inherited Roth IRA as one of her own for purposes of the 5-year rule.
  - The 5-year period continues to run with the participant dies.
    - If a participant dies within the 5-year period, distributions to a beneficiary are taxable until the 5-year period ends.

Roth IRA conversion

Why Convert to a Roth IRA??

-To take advantage of charitable deduction carry-forward, investment tax credits or partnership losses

-No RMDs at age 70 ½ unlike traditional IRAs; provides for greater tax-free growth potential

-Take advantage of market volatility/ account decline and covert prior to rebound to enjoy tax free gains and qualified distributions

Roth IRA conversion

Why Covert to a Roth IRA??

- A taxpayer who can utilize non-IRA funds to pay the income tax due as a result of the conversion can enjoy greater tax-free returns.

-In the event that IRA assets will be used to fund a Credit Shelter Trust, a conversion to the Roth has many advantages

Converting Traditional IRA to Roth

HYPOTHETICAL EXAMPLE

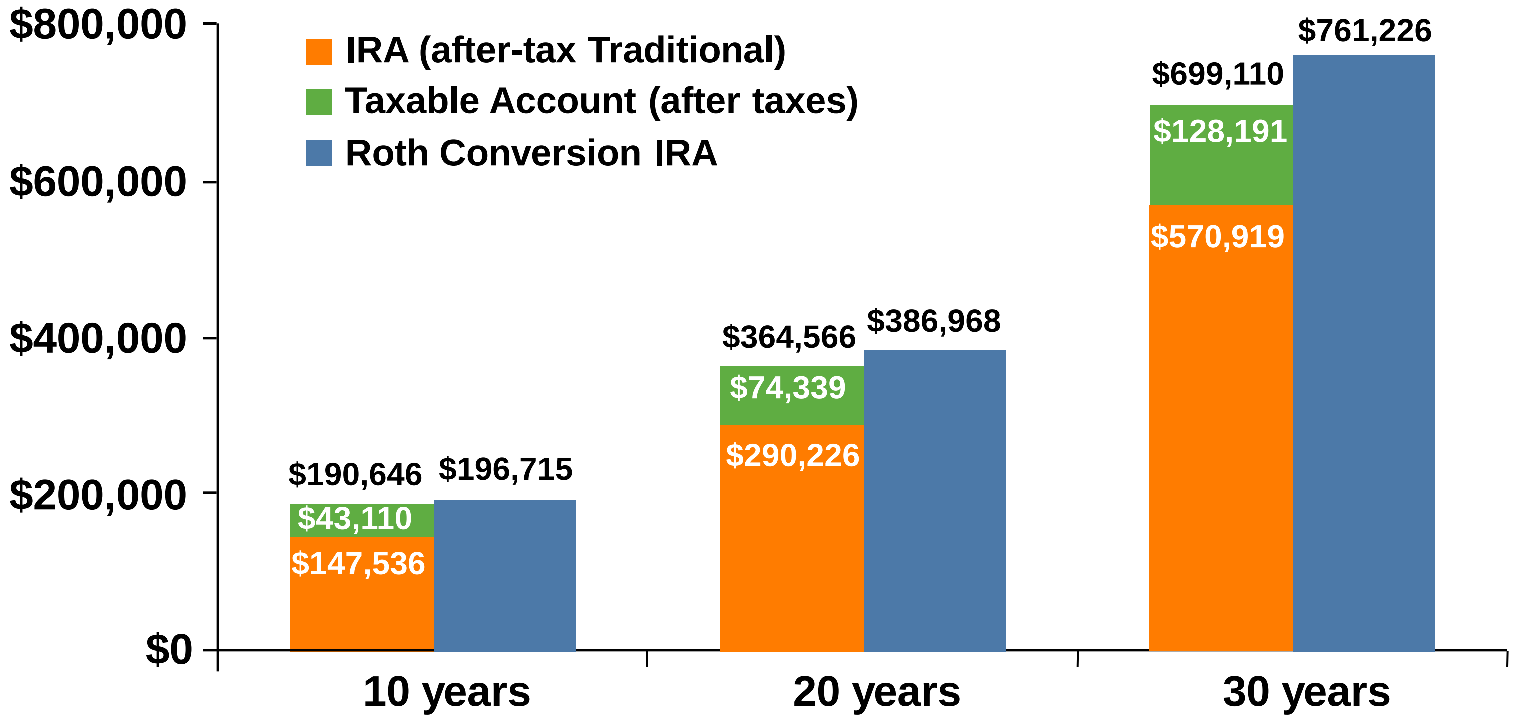
- **Client is 38 years old and married**
- **She has $100,000 (pretax) in a traditional IRA and $25,000 in a taxable account**
- **She is eligible to make a Roth conversion**

Converting Traditional IRA to Roth IRA

HYPOTHETICAL EXAMPLE

Potential Tax Savings

This hypothetical example compares an individual who starts with a $100,000 (pretax) IRA and a $25,000 (after-tax) taxable account. In one example, the person does not make any changes to the accounts and lets them grow at an assumed 7% annual rate of return. In the other example, the person qualifies and converts the IRA to a Roth IRA, using all the assets in the taxable account to pay the income taxes on the conversion.



Roth IRA conversion

Why Covert to a Roth IRA??

-Roth IRA distributions will not result in “bracket creep” or suffer under the higher tax rates usually incurred by a surviving spouse as distributions are tax-free.

-By converting to a Roth IRA during one’s lifetime, the overall estate can be reduced, lowering the impact of higher estate taxes

Roth IRA conversion

IRA vs. Roth IRA- Which is right for me?

- IF… growth rates are the same…

AND… tax rates in conversion and withdrawal years are the same…

THEN after-tax result of both will be EQUAL!!

-Things to consider…

- -Tax rate differential (anyone think tax rates are about to rise??)
- -Are there other funds available to pay the tax?

IRA vs. Roth IRA-

Equal tax rates at conversion and distribution

	Traditional IRA	Roth IRA
Beginning account balance	$100,000	$100,000
Minus income taxes (@40%)	$0	-$40,000
After tax balance	$100,000	$60,000
Growth over 30 years until death	300%	300%
Account balance@ death	$300,000	$180,000
Minus income taxes (40%)	-$120,000	$0
Net amount to heirs	$180,000	$180,000

IRA vs. Roth IRA- Higher tax rate at distribution

	Traditional IRA	Roth IRA
Beginning account balance	$100,000	$100,000
Minus income taxes (@40%)	$0	-$40,000
After tax balance	$100,000	$60,000
Growth over 30 years until death	300%	300%
Account balance@ death	$300,000	$180,000
Minus income taxes (50%)	$-150,000	$0
Net amount to heirs	$150,000	$180,000

Oil & Gas Investments

Tax advantages of Oil & Gas Partnership Investments

- Typical 85% write-off of investment in 1st year
  - Ordinary income if GP investor
  - Passive income if LP investor
- Remaining 15% written off over 7 years as depreciation
- Depletion allowance partially shelters cash flow for the life of the partnership
- Can also help to reduce the Self Employment Tax; GP’s share of income is constituted as net earnings from self-employment

Oil/ Gas Partnership- Who Can Benefit?

- **Must be an accredited investor**
  - **Net worth greater than $1M excluding residence**
  - **Income greater than $200K previous 2 years and expected in the current year**
- **Looking for non-market correlated diversification**
- **High income earners/ one time taxable events**
  - **Sale of a business**
  - **Stock options exercised**
  - **Bonus**
  - **IRA conversion**

Stretching Your IRA

Stretching out an IRA

HYPOTHETICAL EXAMPLE

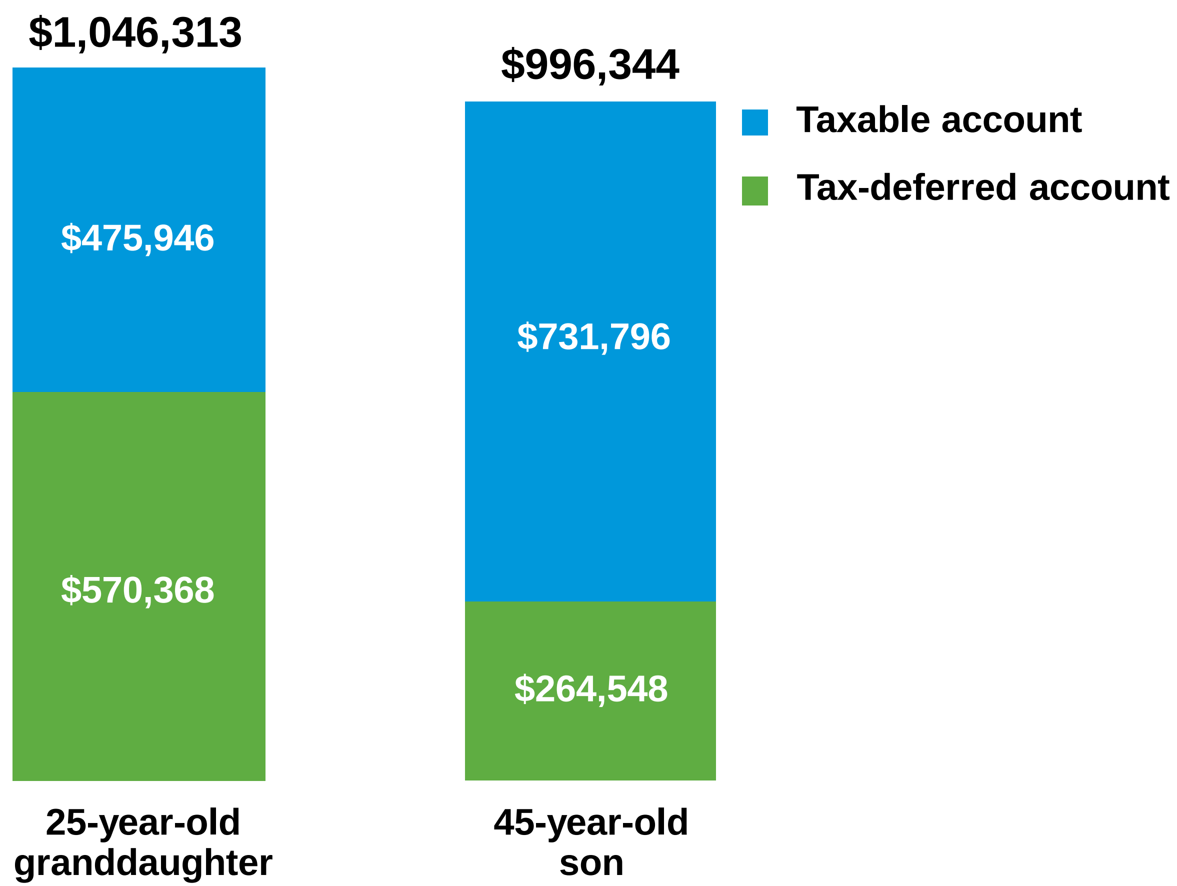
- **Client has a $200,000 pretax IRA retirement account**
- **Two Scenarios**
  1. **Names 45-year-old son as beneficiary**
  2. **Names 25-year-old granddaughter as beneficiary**
- **Client dies before being required to take RMDs**

Transfers to grandchildren are subject to generation-skipping tax (GST).

Stretching out distributions

This hypothetical example compares the after-tax amount potentiality of an IRA inherited by a 25-year-old granddaughter and a 45-year-old son. Assumptions are (1) the IRA had a pretax balance of $200,000 on 12/31 of the year of the owner's death, (2) owner was under age 70½ at death, (3) owner had designated a nonspouse beneficiary as the sole beneficiary of his account, (4) a 7% annual rate of return, (5) distributions from the inherited IRA taxed at a 25% federal ordinary income tax rate at the time of distribution, (6) an imputed constant annual federal income tax rate of 20% on taxable account earnings (based on a mix of long-term capital gains, dividends, and interest), (7) required minimum distributions from the IRA were on the single life expectancy of a nonspouse beneficiary 26 years old in the year after the IRA owner died (57.2 years), and 46 years old in the year after the IRA owner died (37.9 years), (8) the net distribution proceeds from the IRA were invested in a taxable account at the end of each year, (9) all monies were left invested for the entire period except for those used to pay the taxes indicated above, and (10) IRA after-tax value at end of period assumed lump sum distribution at that time. Estate, generation-skipping taxes, state and local taxes, if any, and inflation are not taken into account. This hypothetical is not intended to predict or project the investment performance of any security. Your own results will vary.

Hypothetical after-tax values of a $200,000 (pretax) inherited IRA stretched for 30 years by a 25-year-old granddaughter and a 45-year-old son



Early Retirement

Premature Withdrawals from an IRA or 401k

NUA strategy

NUA is a tax-saving strategy that may benefit those with appreciated company stock in an employer-sponsored retirement plan

- **Participant must:**
  - Be eligible to take distributions
  - Usually take lump-sum distribution of entire account balance*
  - Take in-kind distribution of company stock directly from the plan*
- **Under the NUA rules:**
  - Federal ordinary income tax and any 10% early withdrawal penalty is incurred on the *cost basis*** of the company stock at the time it is distributed in-kind.
  - Long-term capital gains tax is incurred on the net unrealized appreciation at the time you actually liquidate the stock.

Sale of company stock may result in commissions or additional expenses. Talk to your stock plan administrator or custodian to understand the costs of selling stock.

*If a lump-sum distribution is not taken, then only the NUA attributable to employer stock purchased with *after*-tax (non-Roth) employee deferrals should be eligible for this special tax treatment. Any assets that are not eligible for NUA treatment, or on which clients do not wish to elect such treatment, can be rolled over to an IRA or to another qualified plan to preserve their tax-deferred status.
**Cost basis is generally what you paid for the stock.

NUA strategy

HYPOTHETICAL EXAMPLE

- **Client is 55 and retiring early**
- **Client has $100,000 in company stock with a cost basis of $20,000 (all pretax)**
- **Uses NUA strategy to pay ordinary federal income tax on cost basis and moves stock into a brokerage account**

Tax comparison

HYPOTHETICAL EXAMPLE

WITHOUT NUA	
Cost basis of company stock	$20,000
Appreciated value at liquidation	$80,000
Market value at liquidation	$100,000
Total federal income tax @ 25%	**$25,000**

WITH NUA		
Cost basis of company stock	$20,000 x 25%	$5,000
Net unrealized appreciation at liquidation	$80,000 x 15%	$12,000
Total federal taxes		**$17,000**
Tax saving with NUA rules		**$8,000**

Sale of company stock may result in commissions or additional expenses. Talk to your stock plan administrator or custodian to understand the costs of selling stock.

This hypothetical example is for illustrative purposes only. It is not indicative of the performance of any specific investment. Assumptions: a flat 25% federal ordinary income tax rate; 15% long-term capital gains tax rate; company stock was distributed in-kind as part of a lump-sum distribution; all noncompany stock assets were rolled over to an IRA to retain tax-deferred status; no further stock appreciation or depreciation and participant not subject to a 10% early withdrawal penalty. State and local taxes are not taken into account.

72(t) distributions (SEPP)*: early withdrawals without penalties

Internal Revenue Code Section 72(t) (2)(A)(iv) (SEPP) allows penalty-free access to assets in IRAs and employer-sponsored retirement plans under certain conditions.

To take advantage of this option, you must:

- Take a series of substantially equal periodic payments (at least annually)
- Continue taking the distributions – even if you no longer need them – for the longer of five years or until age 59½
- Pay all applicable taxes on the distributions in the year they are withdrawn
- Be separated from service in order to take distributions from a qualified plan

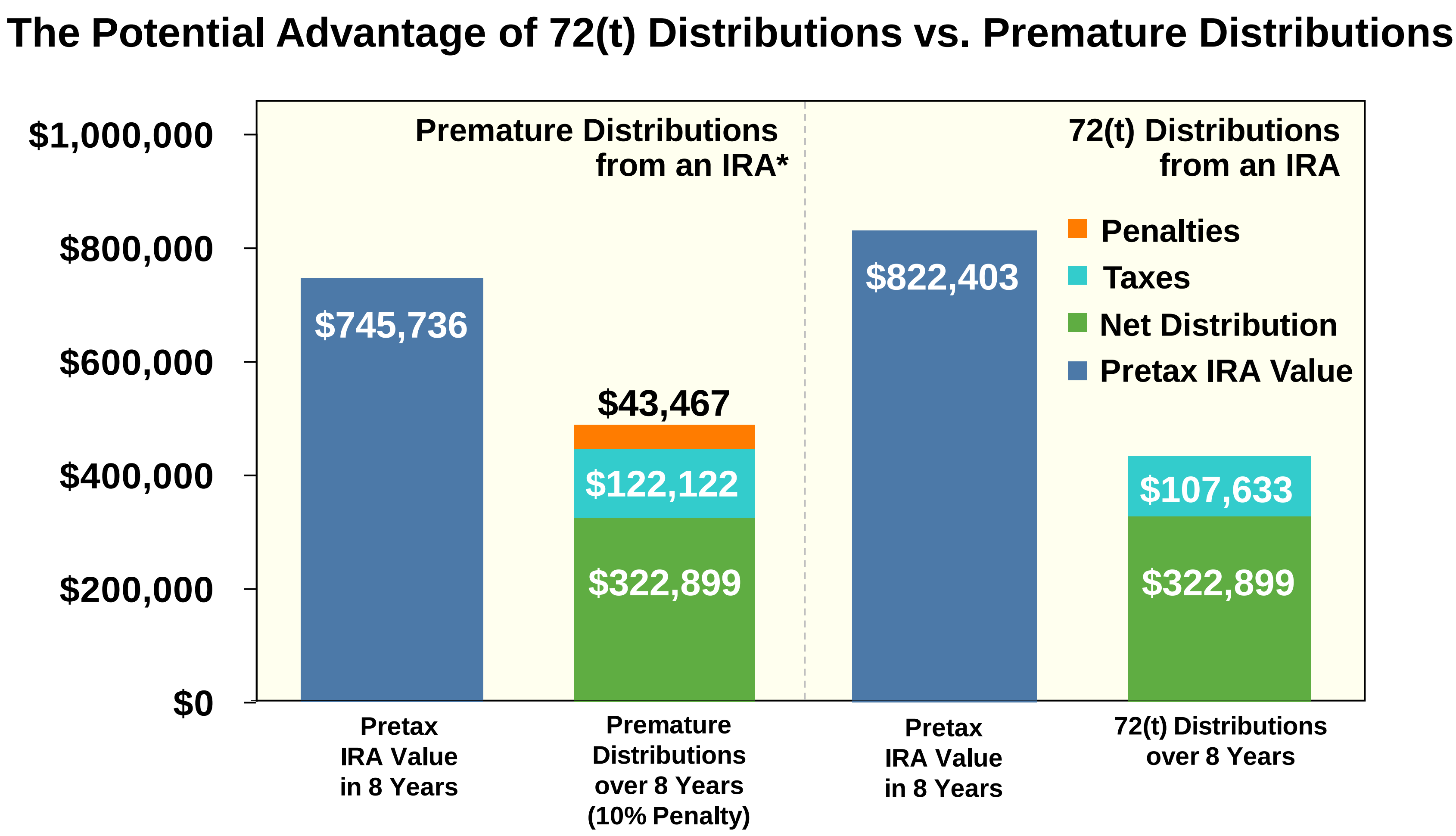
*Substantially Equal Periodic Payment (SEPP)

72(t) distributions (SEPP)

HYPOTHETICAL EXAMPLE

- A 52-year-old owns a 401(k) worth $800,000 (pretax).
- He has left his employer and needs approximately $38,000 (after taxes) a year in supplementary income until age 60, when he will receive a pension.
- His 401(k) does not allow 72(t) distributions, so he rolls over his assets to an IRA to take them.
- Using the annuity method, this early retiree will need to withdraw about $53,816 pretax or $40,362 after tax, assuming a 25% federal tax rate.

72(t) distributions (SEPP): case study



Tax-Efficient Income Distribution

Donating IRA Distributions to Charity

- A taxpayer may exclude from gross income so much of the aggregate amount of his “qualified charitable distributions” not exceeding $100,000 in a tax year.
- Must be made directly by the IRA trustee to a charitable organization (no donor-advised fund)
- IRA owner must have attained age 70 ½
- Original law only applied to distributions made in 2006 and 2007; now extended to tax years 2008 and 2009

Tax-efficient income distribution

- Taxation of distributions during income generation phase can impact your rate of drawdown
- A fully taxable distribution will require that you earn a greater return to avoid significant erosion of principal
- Utilizing multiple “buckets” incorporating different tax treatment can enhance overall tax efficiency of distributions.
- Additional factors relating to taxation of Social Security benefits and top marginal tax bracket need to be considered

Tax-efficient income distribution

- Two investors- Martha and Maria
- Both take $7500 annually from an account
  - Martha's withdrawal is fully taxable
  - Maria has structured her withdrawal to be only partially taxed

	Martha	Maria
Gross withdrawal	$ 7,500	$ 7,500
Taxable portion	$ 7,500	$ 3,920
Net payment	$ 5,400	$ 6,402

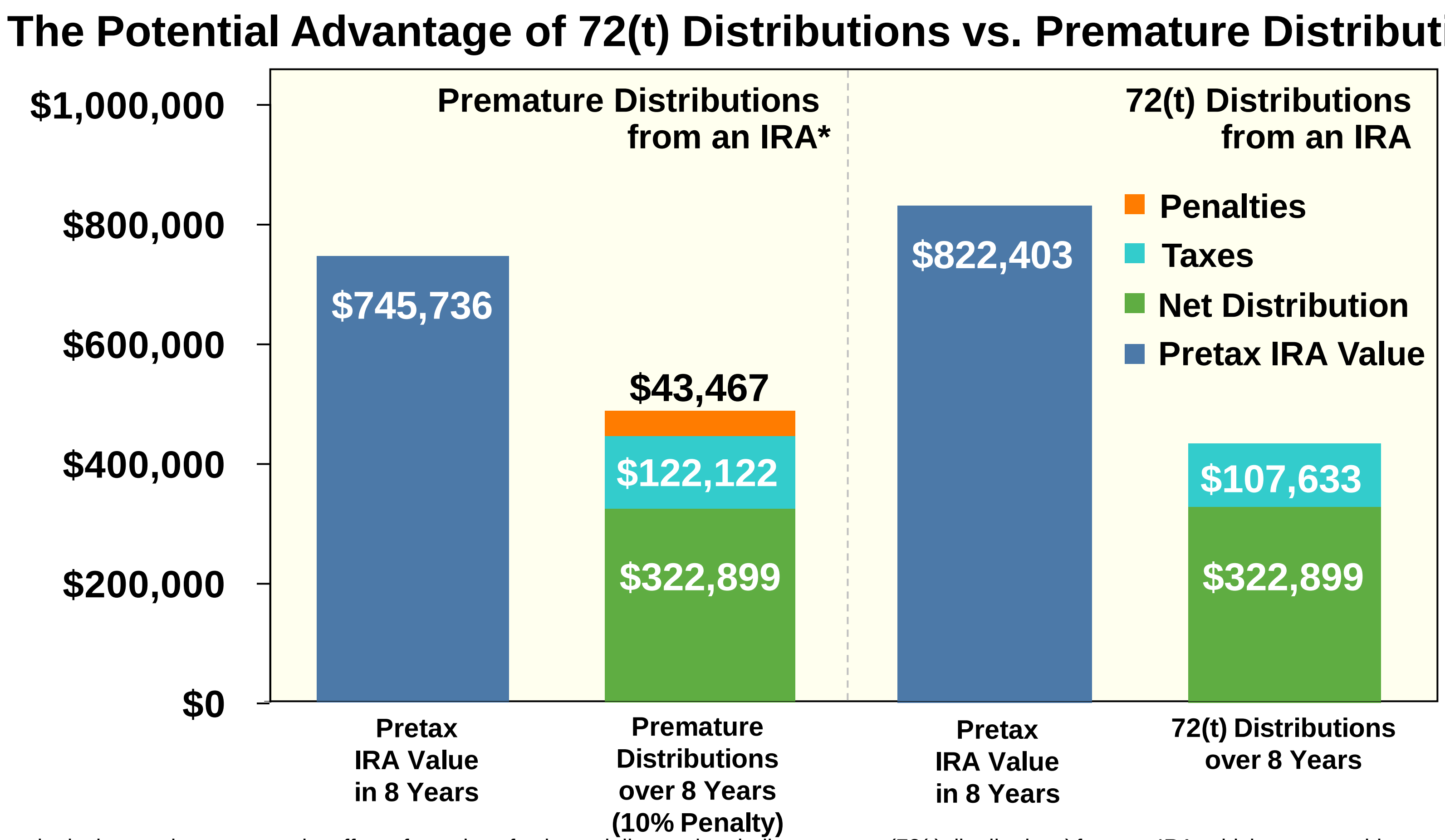
Martha would need to withdraw $8,892 to equal Maria's payment

Tax-efficient income distribution

- $150,000 account value; 28% tax bracket

Age	Wdrwl $$	Wdrwl %	Net paymt	Equiv wdrwl needed	Equiv wdrwl % needed
60	$6,000	4%	$5,107	$7,093	4.73%
65	$7,500	5%	$6,310	$8,764	5.84%
70	$7,500	5%	$6,485	$9,007	6.00%
75	$7,500	5%	$6,744	$9,367	6.24%
80	$10,500	7%	$9,299	$12,915	8.61%

72(t) distributions (SEPP): case study

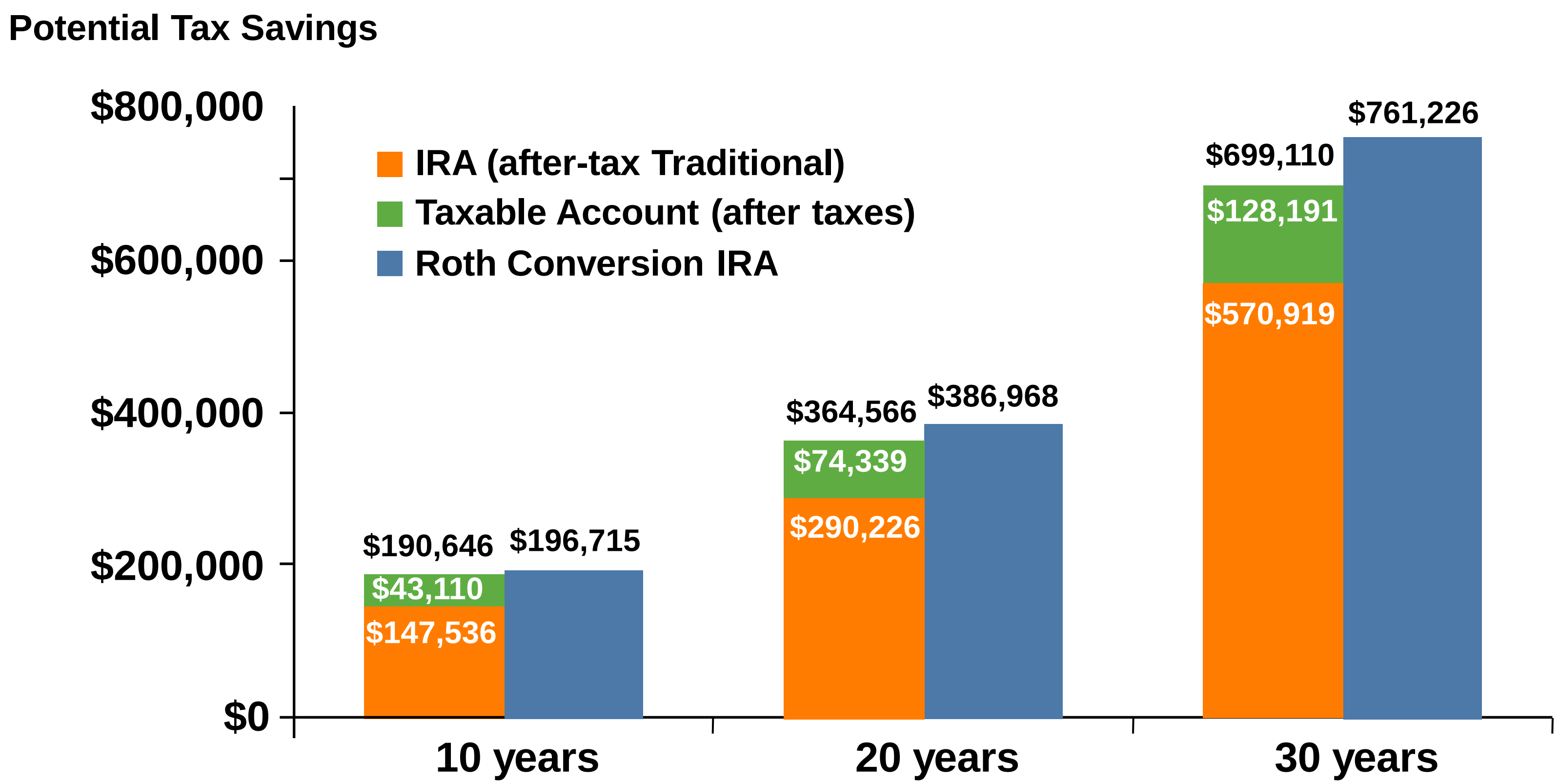


The hypothetical example compares the effect of a series of substantially equal periodic payments (72(t) distributions) from an IRA, which are not subject to a 10% early distribution penalty, and annual premature distributions from an IRA, which are subject to the 10% penalty. It assumes the following: The IRAs each had a pretax value of $800,000 on 1/1 of the first distribution year. The annual rate of return for each IRA was 7%. All distributions were taken annually starting in the year the investor was 52 years old. The annuity method was used to calculate the 72(t) distributions for the second IRA. Based on IRS Ruling 2002-62, an annuity factor of 14.865 was calculated based on an annual interest rate of 5.70% compounded annually (120% of the federal mid-term rate of 4.73% as of 12/06). The annuity method resulted in annual pretax distribution of $53,816, which would be $40,362 after taxes assuming a 25% federal income tax rate. In order to reach the same after-tax amount, assuming the same 25% tax rate, annual premature distributions from the first IRA were $62,096 pretax because of the 10% penalty and additional tax on penalty amount withdrawn.* The distribution schedule for the 72(t) distributions was not modified at any time. No additional contributions were made to either IRA, and no other distributions were taken from them. If the 72(t) distribution schedule was modified after establishment, other than a one-time switch to the required minimum distribution method, each 72(t) distribution would be subject to the 10% penalty on a retroactive basis. This hypothetical illustration is not intended to predict or project performance. Your own results will vary.

* In the eighth year, the premature distribution was only $53,816 because the investor was assumed to be 59½ and not subject to the 10% penalty.

Converting Traditional to Roth

HYPOTHETICAL EXAMPLE



This hypothetical example compares after-tax amount potentiality of leaving $100,000 (pretax) in a Traditional IRA along with $25,000 (after-tax) in a taxable account versus using the entire taxable account to pay the income taxes on a conversion of the Traditional IRA to a Roth IRA. Assumptions are (1) a 7% annual rate of return, (2) Traditional IRA assets converted to Roth IRA are taxed at a 25% federal ordinary income tax rate, (3) an imputed constant annual federal income tax rate of 20% on taxable account earnings (based on a mix of long-term capital gains, dividends, and interest), (4) lump-sum distribution after age 59½ of Traditional IRA assets at the end of the specified periods less 25% for taxes, and (5) Roth IRA assets all qualify for federal income tax-free distribution. State and local taxes, account fees, and expenses are not taken into account. If they were deducted, performance would be lower. The hypothetical is not intended to predict or project the investment performance of any security. Your own results will vary.

Qualified distributions from Roth IRAs are federal income tax free only if the Roth IRA meets the 5-year aging requirement and its owner is at least 59½, deceased, or disabled. Distributions up to $10,000 for a first-time home purchase may also be tax free provided the 5-year aging requirement is met. If the IRA owner is under age 59½ at the time distributions are taken and no exception applies, income taxes and a 10% early withdrawal penalty may apply.