Year-End Planning:
Tax Efficient Investing

Presented by:
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Introduction

About the PFP Section & PFS Credential

• The AICPA PFP Section provides information, resources, advocacy and guidance for CPAs who specialize in providing estate, tax, retirement, risk management and investment planning advice to individuals and their closely held entities (learn more at aicpa.org/PFP)

• The CPA/Personal Financial Specialist (PFS) credential distinguishes CPAs as subject-matter experts who have demonstrated their financial planning knowledge through experience, education and testing (learn more at aicpa.org/PFS)
Introduction

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Tax Aware Investing

KEY TOPICS

► Tax Structure – Determining the “optimum” mix of taxable investments, tax-deferred investments and tax-free investments (i.e. Where should retirement savings be invested?)

► Tax-Sensitive Asset Allocation – Understanding the impact that income taxation has on asset allocation and diversification

► Asset Location – Identifying which assets to place in certain investment vehicles

► Retirement Distribution Strategies to Last a Lifetime – Integrating tax structure, tax-sensitive allocation and asset location to ensure that retirement funds will last a lifetime
Tax Structure
Determining the “Optimum” Mix of Investment Vehicles/Structures
TAX ASSET CLASSES

- Money market
- Corporate bonds
- US Treasury bonds

Equity securities
- Qualified dividends at LTCG rate
- Return of capital dividend
- Capital gain dividends

Equity Securities
- Deferral until sale
- Reduced capital gains rate
- Step-up basis at death

Attributes
- Annual income tax on interest
- Taxed at highest marginal rates

Bonds issued by State and local Governmental entities
- Pension plans
- Profit sharing plans
- Annuities

Attributes
- Federal tax exempt
- State tax exempt

Attributes
- Growth during lifetime
- RMD for IRA and qualified plans
- No step-up

Roth IRA
- Tax-free growth during lifetime
- No 70½ RMD
- Tax-free distributions out to beneficiaries life expectancy

Real Estate
- Depreciation tax shield
- 1031 exchanges
- Deferral on growth until sale

 Attributes
- Large up front IDC deductions
- Depletion allowances

Oil & Gas
- Tax deferred growth

Attributes
- Tax-deferred growth
- Tax-exempt payout at death

Life Insurance

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Tax Asset Classes is a service mark of Robert S. Keebler, CPA, MST, AEP and Keebler & Associates, LLP
Income Taxation Basics of Retirement Investments

Three Main Types of Retirement Investment Accounts

- **Taxable investment accounts** – income generated within the account (i.e. interest, dividends, capital gains, etc.) are taxed each year to the account owner.

- **Tax-deferred investment accounts** (e.g. traditional IRAs, traditional qualified retirement plans, non-qualified annuities, deferred compensation) – income generated within the account is not taxed until distributions are taken from the account.

- **Tax-free investment accounts** (e.g. Roth IRAs, life insurance) – income generated within the account is never taxed when distributions are made (provided certain qualifications are met).
Investment Incentives in the Tax Code

- Qualified dividends
- Long-term capital gains
- Qualified retirement accounts (e.g. 401(k) plan)
- Roth IRAs/Roth 401(k) plans
- Real estate depreciation
- Oil & gas
- Life insurance
- Non-qualified annuities
- Master Limited Partnerships (MLPs)
- Index options
Deductible IRAs, Pension Plan Incentives and Deferred Compensation

- Deductible contributions
- Tax deferred growth
- Taxable withdrawals
- Net Unrealized Appreciation (NUA)
- Lump-sum averaging
- Aggregation of accounts
- Roth IRA conversions
Roth IRA and Roth 401(K) Incentives

- Non-deductible contributions
- Tax-free growth
- Non-taxable withdrawals for “qualified distributions”
- Five-year rule & Age 59 ½ Rule
Qualified Dividend Incentives

- Taxation of Interest Income - Ordinary Income
- Taxation of Traditional Dividends - Ordinary Income
- Taxation of “Qualified Dividends” – Capital Gains Rate of 15%
Capital Gains Incentives

- Gains Deferred until Property is Sold
- Short-term Gains are Taxed at Ordinary Rates
- Long-term Gains are Taxed at Lower Tax Rates
- Step-up in Basis at Death
- Gifts to Charity or a Charitable Trust that do not Trigger Tax
Real Estate Incentives

- Interest Deductions
- Depreciation Tax Shield
- 1031 Tax-free Exchanges
- Step-up in Basis at Death
Oil and Gas Incentives

- **Intangible drilling costs (IDCs)** provide a large immediate income tax deduction (up to 85% of the initial investment)
  - Losses, if any, created as a result of IDCs will be ordinary (thus lowering a taxpayer’s AGI)
    - Must be a general partner in the first year
    - Possible AMT add-back issues if IDCs exceed 40% of AMTI

- **Depletion and other depreciation** (including Section 179 expensing) provide for additional deductions during the term of the investment

- **Additional tax credits** may be available for certain oil & gas ventures

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Life Insurance Incentives

- Tax-Deferred Growth
- Tax-Free Death Benefit
- Tax-Free Basis Distributions First
- Tax-Free Loans
- All Contracts are Treated Separately
- Modified Endowment Restrictions
Nonqualified Annuity Incentives

- Tax-deferred Growth
- Pro-rate Basis Distributions if Annuitized
- All Contracts are Treated Separately
Incentives for Master Limited Partnerships

- Cash Distributions are often Tax-free
- Depreciation Tax-shield
- Reduction in Basis
- Step-up in Basis at Depth
Incentives for Listed Index Options

- 60% Long-term Capital Gain
- 40% Short-term Capital Gain
- Effective Tax Rate of 23%
  - \(((15\% \times 60\%) + (35\% \times 40\%))\)
- “Marked to Market” Taxation at Year End
Blending Tax and Finance

- Asset “Allocation”
- Tax Incentives
- Asset “Location”
Common Problems Blending Tax and Finance

- Large IRAs and Qualified Plans
- Minimal IRAs and Qualified Plans
- High Turnover Investments
Asset Location
Traditional IRA/Roth IRA Observations

- Bonds (or other ordinary income producing assets) should be placed in IRAs (traditional/Roth) instead of taxable investment accounts.
- Lower turnover equity investments (i.e. long-term capital gain assets) should be positioned in taxable investment accounts.
- Roth IRAs are slightly better than deductible traditional IRAs and taxable investment accounts with low turnover equity investments.
- Roth IRAs are much better than non-deductible traditional IRAs and taxable investment accounts with ordinary income producing assets.
Tax-Deferred Annuity/Life Insurance Observations

- Bonds (or other ordinary income producing assets) should be held in a tax-deferred annuity or life insurance.

- Low turnover equity investments should be held in a taxable investment account.

- Life insurance is much better than taxable investment accounts with ordinary income producing assets) because of the tax-free nature of the income.
Tax Aware Investing Observations - What have We learned?

- Life Insurance is on Extremely Efficient “Tax Asset Class” for Bond Type Investments
- Tax-deferred Annuities are more Efficient than Bond Type Investments
- Passive Low-turnover Investments provide a Higher After-tax Return on Investment than more Active Strategies generating Short-term or Long-term Capital Gains
- The Real Capital Gains Rate on a Present Value Basis is Substantially less than the 15% Statutory Rate
Is Tax Deferral Always the Best Strategy?

- Under the new tax law, the tax leverage benefits of deferring may not always exist.
- Lower tax rates and narrower tax brackets may require balanced strategy.
- Too much Deferral creates the “Disproportionate IRA” problem.
Understanding Tax Adjusted Asset Allocation

- Currently Most Asset Allocation Models Use Standard Pre-tax Return and Standard Risk Assumptions
- Income Tax “Drag” should be Taken into Account
- Income Tax Rates vary by Taxpayer
- Capital Gains are Taxed at Different Rates
- Conflicts with the Current Practice(s)
Beyond Asset Allocation
Understanding “Asset Location”

Concept:

• Begin with “Tax-adjusted” asset allocation
• Once you know the proper asset allocation, then you need to select “Asset Location”
• Asset Location is driven by:
  - Tax benefits associated with the proper location of equities and fixed income
• General Rule: Fixed income should be held in Retirement Accounts, Annuities or Life Insurance
• General Rule: Equities should be held in taxable accounts
Ideal Assets for Qualified Plans and IRAs

- Taxable Bonds
- REITS
- High Turnover, Short-Term Gain Strategies
- Nonqualified Dividends
- High yield Stocks
- Option Strategies
Ideal Assets for Taxable Accounts

- Low Turn-Over Gain Strategies
- Qualified Dividend
- Long-Term Capital Gain Strategies
- Real estate Investments
- Oil and Gas Investments
- I Bonds
- Tax-Exempt Bonds
- Master Limited Partnership
Assets for Roth Accounts

- High Turnover Equity Strategies
- Small Cap Growth and Value Strategies
- Option Strategies
- Certain Hedge Funds
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PFP Section Resources (aicpa.org/PFP)

- **The CPA's Guide to Financial & Estate Planning**—1000-page, 4 volume, in-depth guide for practitioners (updated for ATRA)

- **Forefield Advisor** ([aicpa.org/pfp/forefield](aicpa.org/pfp/forefield))
  - Client education and communication tool
  - Written by CPAs, attorneys and other subject matter experts
  - More than 3,000 resources covering personal financial planning, including estate, tax, retirement, investment and risk management planning

- **Where to find more education**
  - Webcasts:
    - To register and to view the full calendar of upcoming PFP Section events, visit [aicpa.org/PFP](aicpa.org/PFP) and click on CPE & Events.
    - *To access the archives, visit [aicpa.org/pfp/webseminars](aicpa.org/pfp/webseminars).
  - AICPA Advanced Personal Financial Planning Conference ([cpa2biz.com/PFP](cpa2biz.com/PFP))
    - Advanced education covering tax, estate, retirement, investments and risk management planning to be ready for 2014 and beyond
    - 2-day pre-conference workshop on implementing a PFP practice, Jan 18-19
Resources for Post-ATRA & NIIT Planning

▶ Planning After ATRA and the Net Investment Income Tax Toolkit
  • aicpa.org/pfp/proactiveplanning
  • Complimentary PFP Section member/PFS credential holder benefit
  • Includes infographic on tax brackets, planning ideas to use in client meetings, client communication templates, webcast/podcast archives, and more!

▶ Other Resources for Purchase from Bob Keebler (www.cpa2biz.com)
  • Tax Planning After the Healthcare Surtax: Tools, Tips, and Tactics*
  • The Rebirth of Roth: A CPA's Ultimate Guide for Client Care*

▶ Coming soon! More Resources for Purchase from Bob Keebler*
  (www.cpa2biz.com)
  • Planning Opportunities After ATRA: Tools, Tips, and Tactics (PTX1307M)
  • Tax Rate Evaluator: A Graphical Calculator for Tax Planning After ATRA (PTX1306M)

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