# TAX PLANNING

# INTRODUCTION

## DO WHAT YOU WANT, BUT DO IT IN A TAX-SMART WAY…

While federal income tax rules are now more complicated than ever, the benefits of good tax planning are arguably more valuable than ever before.

Tax planning means deferring and flat out avoiding taxes by taking advantage of beneficial tax-law provisions, increasing and accelerating tax deductions and tax credits, and generally making maximum use of all applicable breaks available under the Internal Revenue Code. Taxes are often the single greatest expense many people will have in their lifetime. Knowing the rules and (more importantly) how to use those rules to keep your taxes low means more money in your pocket and more freedom to do the things you want to do!

Of course, you shouldn't change your finances solely to avoid taxes. Truly effective tax planning allows you to do what you want while reducing your tax bills along the way.

Hopefully some of the ideas you find here will help start you along the way to saving taxes, but remember that true tax planning should be done with the help and advice of a professional…someone who not only knows the rules, but knows you and cares about your financial future.

*© 2012-2016 Lakes Publishing, LLC*

*“There is nothing sinister in so arranging one’s affairs so as to make taxes as low as possible.”*

*“Everybody does so, rich or poor, and do right, for nobody owes any public duty to pay more taxes than the law demands.”*

*“Taxes are enforced exactions, not voluntary contributions.”*

*Justice Learned Hand*
*United State Appellate Court*

When it comes to protecting your piece of the American Dream, the biggest problem all of us face is taxes. We all know that the tax man wants as much money as he can get, and year after year he just keeps on taking from taxpayers. Even worse, if you manage to make more money, the tax man expects you to give him even more of it.

It seems that every time we come into contact with money, we are taxed. We pay taxes when we earn it, we pay taxes when we spend it, we pay taxes when we save it, we pay taxes when we give it to someone else, and we are going to pay taxes when we die. Yet what’s funny is that our country was founded by people who were tired of paying so many taxes!

## A BRIEF HISTORY OF THE TAX CODE

Think about the Boston Tea Party; all that tea was dumped into the Boston harbor because Americans were letting England know that they weren’t going to pay taxes on their tea. Our forefathers took a stand against taxation without representation, but look at where we are in the 21st century. Do you believe you are being well represented when it comes to taxes? Did you vote to have your Social Security income taxed? How about the taxes that are added to your cell phone bill? Most people pay a city and state tax just for using a cell phone. You certainly didn’t ask for that. Your city and state simply added them on because they decided it was for a good cause.

As recently as the year 2000, the United States had a budget surplus. Of course, once the economy stumbled and we began the war in Iraq after September 11, 2001, that amount quickly disappeared. Now we have a deficit.

In the late 1990’s when we supposedly had a surplus, I began asking people if they believed that our country’s surplus really existed. The vast majority said “no”, and many thought it was an outright lie.

Two things had to happen in order for that surplus to last. First, we were told that the surplus would last if we did not have a recession in the next 10 years. Of course, the late 90’s was a time when the United States was in the longest economic expansion period of its history. So spending was increasing almost daily. Regardless, everyone will agree that the economy took a tumble after September 11, 2001. And while things bounced back, the recovery was temporary. We are still trying to recover from the Great Recession of 2008!

Second, we were told that in order for the surplus to last the United States would have to cut its spending by 20% over the same 10 years. Our country has never had a president who left office spending less than when he took office. Many have pointed out that President Reagan spent less during his term in office. But once debt issuances were included, this was no longer the case. Most

importantly, Congress didn't even include the biggest debt this country has, Social Security, in its supposed surplus.

An article from CBS Market Watch in October 2003 summed up the state of things. At the time, the projected budget deficit for fiscal year 2004 was $600 billion, thanks in part to the war in Iraq. Yet as President Bush's term in office continued, we saw unlimited tax cuts for the ultra-wealthy and limitless spending. And as we are all aware, the deficit exploded during President Obama's first term as President. By the time our soldiers left Iraq, the deficits were out of control.

According to William Gale, an economist with the senior Bush's Council of Economic Advisors, and Peter Orszag, a special assistant to Clinton on economic policy, our nation had gone from an annual surplus of $127 billion in 2001 to a $300 billion deficit in 2003. These PhD-educated economists also expected the deficit to double in 2004 and determined that the overall federal account would shift from a long-term surplus of $5.6 trillion to a deficit of $2.3 trillion.

What's worse, according to Gale and Orszag, was that the official numbers used by the government were misleading because they were based on accounting measures that would have made Enron green with envy.

First, the government bases its figures on the assumption that sunset provisions tied to temporary taxes will never occur. In other words, the government expects that current "temporary" taxes will eventually become permanent.

Second, the government assumes that federal spending will only go up with inflation and not outpace it. As we've seen over the last few years, that's hardly the case.

Lastly, the government is able to make the deficit appear lower because cash flow surpluses from Social Security, Medicare, and federal employee pensions are not included in their accounting methods.

Now, imagine what will happen when baby boomers continue to retire in the next 10 years. This potential drain on Medicare and Social Security hasn't even been taken into account.

In order to balance the budget, Gale and Orszag insist that Social Security and Medicare spending would have to be cut by 41%. Of course, no politician is ever going to vote for that kind of a cut for Social Security and Medicare, but does that mean you shouldn't worry? Not hardly.

The bottom line is a real surplus never existed, and today we have a huge deficit. That means that we all have to pay taxes to fund our military, education, welfare and the rest.

Our spending has dramatically increased over the last several years…and that spending threatens to increase our taxes.

Congress claims to have enacted lots of tax law changes over the last few years to help us all out. But has it made a difference?

All the restructuring that's gone on the past few years is really nothing but congressional tax shenanigans. As usual, the wealthy pay less in taxes. And who is asked to pick up the slack? Middle income America (the backbone of this country).

As investors, your response to these shenanigans should be to develop a tax strategy that takes advantage of the rules and arranges your affairs accordingly.

© 2012-2016 Lakes Publishing, LLC

When it comes to taxes, this is what you should strive to do. In fact, it is possible for many senior investors to pay only 4% in taxes on their income by using just a few techniques. It may sound too good to be true, but everything we will discuss in this chapter is absolutely legal. This is not about offshore trusts or tax-dodging schemes, but applying 30-year-old tax strategies to your investments – most likely, things that no one has ever gone over with you.

Take another look at the quote in the beginning of this chapter. Judge Hand basically said that as U.S. citizens we are allowed to arrange our affairs in order to pay the least amount in taxes legally possible. In fact, he said it is our duty to do so. After all, isn't that what our country was founded on?

I'm proud to be an American and willing to pay my fair share of taxes, as long as our government gives me something in return such as improved roads, better schools, and military defense. But our government also wastes an awful lot of money…money it also gets from hardworking Americans like you and me. And you and I can be just as proud of America for half as much money. Don't you agree?

***The New York Tycoon***

*There was once a very wealthy New York tycoon who needed to borrow $10,000 for a trip to Europe. When he went to his bank to borrow the money, the young banker asked the tycoon what he intended to use as collateral for the loan.*

*"My Rolls Royce is parked outside," he told the young banker. "You're welcome to hold it until I pay you back."*

*The banker agreed that the car would suffice, so he took the tycoon's keys and placed the Rolls Royce in a secured garage to protect it from damage and theft. Once it was securely parked, the banker finished the loan, and the tycoon left with his $10,000.*

*Two weeks later, the tycoon returned from his trip and went to the bank. "I've come back to pay off my loan and get my car back," he told the young banker.*

*"Of course," the banker responded. As the two were finishing up the loan paperwork, the banker had the Rolls Royce brought from the secure garage. "I must admit that I'm confused," he told the tycoon. "When filling out the paperwork for the loan, I did a credit check on you and found out that you're worth more than $30 million. With so much money, why did you need to borrow $10,000?"*

*"Where else in Manhattan can you park your car in a secure garage for $37 a week," the tycoon laughed. The tycoon wasn't breaking the rules by borrowing money to park his car; instead, he was using them to his advantage. He's a perfect example of someone who knows the rulebook and uses it in his favor.*

© 2012-2016 Lakes Publishing, LLC 

## A TAX ON A TAX

While there are some taxes you can't do anything about, there are four taxes that you can significantly reduce with a little bit of easy planning!

1. You can reduce taxes on your interest and dividends
2. You can reduce taxes on your capital gains
3. You can reduce or eliminate taxes on your death
4. Many investors can reduce or eliminate taxes on Social Security income.

Social Security is one of the most important areas to address when looking at your tax situation. Taxes on your Social Security income are a tax on a tax. Social Security was a tax you were forced to pay for all of those working years, and now you are still taxed when you get that money back. The government gets you coming and going!

Several times a year, I attend symposiums for the financial services industry. And at these gatherings, I ask my fellow associates what they are doing about their clients' Social Security tax.

"Nothing," they always tell me. "It's no big deal." Of course, they say that because it's not a big deal to them. But 20 or 30 years from now when they start drawing Social Security, they'll have a different view. And any advisor who thinks this way does not have your best interests at heart.

As you know, FDR created Social Security back in 1935. And three years later people started receiving benefits. At the time, the U.S. Treasury said that Social Security was a gift and that it would never be taxed. Well, to be honest, it wasn't a gift. Since when do you have to pay for a gift?

But even though FDR promised that Social Security would never be taxed, look at what happened. It shouldn't be surprising; after all, what do politicians find easy to make, but hard to keep? Promises.

Unlike most politicians, FDR kept his promise. But in 1983, Congress created a law that allowed 50% of your Social Security income to be taxed. To make matters worse, Congress increased that amount to 85% in 1993. And it won't be long before Congress decides it's okay to tax that last 15%.

When you worked, did you and your fellow employees meet in a back room once a year to vote yourselves raises? That's what Congress does. Every year, members of Congress meet. And despite current layoffs, a bad job market, and people with little money to spend, Congress gives itself an increase in salary. It usually happens on a Saturday night, so that it attracts little attention in the Sunday newspaper…and by Monday, other news has made people forget all about it.

Factor in that most members of Congress are either millionaires or owe their election to gifts from millionaires, and they have little incentive to lower taxes on Social Security income. Since it doesn't affect them, why should they care?

- 66% of Senators Are Millionaires
- 41% of the House of Representatives Are Millionaires
- 1% of Americans Are Millionaires

*Though in 2011 Congress finally got the message and voted to block the annual pay raise.[2]

## WHEN IS "TAX FREE" NOT TAX FREE?

If you own tax-free municipal bonds, you may already realize that they aren't really tax-free. When you file your 1040 every year, you have to report any tax free interest you receive, which includes interest from these bonds. So if these bonds are truly tax-free, why are you required to report the interest?

Because they are taxed when you begin receiving Social Security.

Tax-free municipal bonds are tax-free for people in their 20's, 30's, 40's, and 50's. But for retirees? No way. You are taxed when you draw Social Security. Washington continues to treat the Greatest Generation poorly…and that's a crime.

I once met a woman who exemplified this perfectly. As she introduced herself, she was feeling very proud because her broker had put her in $250,000 worth of municipal bonds. The woman took out her statement and showed me. I looked at the statement and said, "Oh, I'm so sorry."

"What do you mean?" she said.

I asked if I could see her tax return. When she showed it to me, I immediately saw that those $250,000 of municipal bonds were causing her to pay an additional $3,000 in taxes each year.

Talk about killing the messenger! Once I explained this to her, I was barely able to get her out of the office while I was still alive. Apparently, the truth can hurt.

It was obvious that her broker had never looked at the woman's tax return. So do you think her broker ever explained to her that her tax-exempt bonds could be taxable? Absolutely not.

This can be confusing if you don't understand how Social Security is taxed. So if you want to know just how much of your Social Security is being taxed, get your most recent 1040 and do the following:

---

1. *Add lines 7 and 8a*
2. *Add line 8b (tax-free income)*
3. *Add lines 9a through 19*
4. *If you are married and earn more than $32,000 (or single and earn more than $25,000) add 50% of your Social Security Income. If you are married and earn more than $44,000 (or single and earn more than $34,000) add 85% of your Social Security income.*

---

This total is your provisional income, and the IRS uses this number to determine how much of your Social Security income is taxed. You can see that the tax on your Social Security is based on a lot more than just your Social Security income.

*© 2012-2016 Lakes Publishing, LLC*

## THE GOOD STEWARD IS PUNISHED

Do you see how the system is designed to work against you? It's frustrating because not only did your generation build this county, but you were also good savers. You believed that "a penny saved is a penny earned" and trusted the motto "waste not, want not." Your taxes made Social Security what it is today; yet instead of being thanked and rewarded for your efforts, you are being taxed. Quite simply, you are a generation of good stewards who are being punished for your hard work.

On top of this, each year the tax brackets go up a little bit so that they are adjusted for inflation. This means the income needed to reach the 15% tax bracket goes up a little bit, the income needed to reach the 28% tax bracket goes up a little bit, and so does the income needed to reach all of the other brackets.

Your deductions are also indexed for inflation. So are your ex emptions. In fact, everything is indexed for inflation except for…you guessed it, Social Security. This means that since the IRS started taxing Social Security in 1983, they have not indexed any of those Social Security brackets for inflation.

Of course, in 1983, $32,000 was a pretty darn good income. At the time:

- The average income was $21,073 a year
- The average home cost $82,600
- The average car cost $8,577.

What is $32,000 going to get you today? Not much.

So when Congress and politicians tell you that they are going to help you reduce your taxes, you should be skeptical. After all, how much have the recent tax breaks helped you? Probably not much.

## THE BOTTOM LINE

What is really upsetting is that seniors are the most influential group of voters in this country. AARP has more clout on Capitol Hill than anyone else, and no politician in their right mind would speak out against AARP. But we still get hood winked by having our Social Security subject to double taxation.

The bottom line is that it's the same as it's always been. The people who benefit the most from the recent tax law changes are the very wealthy. The vast majority of middle-class, hardworking people like you will not benefit from these tax law changes.

So, how do you get a tax break? You become informed.

## HOW YOUR INVESTMENTS ARE TAXED?

Now that we've talked about municipal bonds being taxed and the importance of reducing your taxes on your Social Security, we are going to discuss mutual funds. And when it comes to mutual funds, there are a few key things you need to know.

First, you should understand that all mutual funds must dis tribute 90% of everything they earn as capital gains and dividends. If you've owned a mutual fund for more than a year, you'll receive a tax form 1099 as a result. This reflects your capital gains and dividends, which means even though you are holding the fund, you still have to pay taxes on it.

*© 2012-2016 Lakes Publishing, LLC*

Of course, we were all told how much the new tax treatment of dividends was going to help us. Just about everyone in Washington explained time and again that we'd get a huge boon from this change. But in hindsight, who did it really help?

The tax-favored status of dividends is wonderful for the super-rich. All of their shares of DuPont, Exxon, or whatever company from which they receive dividends puts them in the tax bracket of a waitress. On the other hand, the middle-class, which owns mutual funds (instead of millions of dollars in individual company stock) are once again taken to the cleaners. This is because mutual funds pay the internal fees using dividends first. That means the tax-favored status of dividends is gob-bled up by fund fees. As a result, you won't ever receive the tax advantage from this status.

## THIS RATIO KILLS RETURNS

Depending on your experience with mutual funds, you may or may not know what a "turnover ratio" is. Turnover ratio is a statistical way of saying how many stocks are bought and sold by a mutual fund each year. For example, let's say you own a mutual fund that invests in 100 different stocks, and that fund has an annual turnover ratio of 94%. This means that out of those 100 stocks, the fund manager is going to sell 94 of them this year, and replace each of those with a different stock.

By today's standards, a turnover ratio of 130%[3] is considered average. Yet 10 years ago, the average turnover ratio was only 24%. Each year this ratio has gone up, and some fund managers are selling and buying stocks as if they were day traders. I've seen mutual funds with a 400% turnover ratio. This means that if the fund has 100 stocks, the fund manager will sell all 100 stocks, and then replace them with something different. And he's going to do it again, and again, and again. In other words, he's going to sell every stock in the fund an average of four times over the course of just one year. Each stock in the fund would be held for an average of just three months.

And if you own a mutual fund with a high turnover ratio, you can imagine what it would do to your tax situation. Every time the manager sold a stock, he or she would have capital gains to contend with. And we said a moment ago, 90% of all capital gains must be distributed – which means they give them to you, and you end up paying taxes on them.

Of course in theory, fund managers who buy and sell stocks on a constant basis do so to improve the fund's returns and capital gains, but it rarely turns out that way. Their hearts are in the right place –but you get clobbered when it comes to taxes.

Look at it this way: when you sell a stock within 12 months of buying it, the stock is considered short-term. And when you sell a stock more than 12 months after buying it, the stock is considered long-term.

As you know, short-term gains are much worse for taxes than long-term gains. In fact, short-term gains mean you'll pay anywhere from 33% to 50% more in taxes than you would for long-term gains.

So if a manager is constantly buying and selling stocks inside a mutual fund, the tax treatment of that fund is going to be extremely poor. But your advisor is probably not telling you that.

## FE FIFO HIFO FUM

Another issue that affects taxes of mutual funds is, "which shares are sold and when"? Anyone that calculates capital gains on their taxes is familiar with the different kinds of record keeping the IRS

*© 2012-2016 Lakes Publishing, LLC*

will accept. There is FIFO (First In, First Out) which is the most expensive way of handling capital gains, and there is HIFO (Highest In, First Out) which means that they are selling the highest-priced shares of that company first, regardless of when you purchased them.

Let's say you've bought some shares of XYZ stock at $10, some more at $20, and some more at $30. Now you want to sell some of those shares, and the going price is $40 a share. You would want to sell the shares using HIFO, which would give you a minimal gain of $10 on each share. If you sold the same number of shares using FIFO, you'd see a gain of $30 per share, and you'd pay more in taxes… even though you'd receive the same amount for your sale. That's a huge difference!

Most people who don't know better (or haven't kept good re cords) determine their gains by using the FIFO method. But as you can see, those who take the time to keep track of their transactions often use the HIFO method and save themselves a lot of money on capital gains taxes in the process. The IRS doesn't care which method you use, as long as you are consistent and your records support the method you choose.

Well, mutual fund managers are just like individual investors when it comes to their capital gains. Some go to the trouble of keeping good records and using the HIFO method to save money on capital gains, while other funds don't worry about it and are forced to use the FIFO method. About an equal number of funds use each method, meaning there is a 50/50 split between users of FIFO and HIFO.

*Mutual Fund* magazine once asked funds that use FIFO why they didn't use the HIFO method since it would save their investors' money on capital gains. The majority of fund companies replied that it was just too much work to keep track of it that way.

It's easy to say something is too much work when someone else has to deal with the repercussions of your laziness. So while funds may not think it's important to bother with using HIFO, you'll pay the price for their laziness – in extra taxes. Warning: It gets even worse because of a recent tax law change. Individual stocks and bonds in your Brokerage Account will fall prey to this very same problem beginning in 2013.

## PHANTOM INCOME

By far, one of the most frustrating things about mutual funds is "phantom income". This occurs when you lose money on a mutual fund, but still get hit with a HUGE tax bill at the end of the year. A few years ago when every fund was making money this was almost unheard of. But today, it's becoming a common occurrence. If you want to avoid phantom income, watch your fund's capital gains and turnover ratio.

Even if you ignore the tax issues, high turnover rates are still a bad thing. Let's say that a fund manager sells off $30 million of a particular stock in his fund. When he or she sells that much stock, the price of the stock usually goes down in response to selling pressure. So at this point, the manager may end up with $29 million in cash from the process of the sale (remember selling pressure caused the price to drop as he sold). Now let's say the manager uses that cash to purchase a new stock. And when someone purchases that much stock of one company, the price of the stock goes up due to buying pressure. So at this point, the fund now has $28 million of the new company's stock.

In other words, the fund started out with $30 million of the old stock, and replaced it with $28 million of another stock (because of the buying and selling pressure affecting the price). When this happens, the fund has to recoup two million dollars just to break even. That means the fund

manager now has to take more risk in the market to cover his loss. Essentially, the higher the turnover ratio, the riskier the fund.

## GOOD FOR THE GOOSE…BUT NOT THE GANDER?

By the way, isn't it interesting that advisors tell us to buy and hold stocks, then turn right around and suggest funds where the managers are churning through stocks on an almost daily basis? It's as if what's good for the goose isn't good for the gander. So if you are a buy-and-hold investor, you owe it to yourself to make sure your funds are buy-and-hold as well. And the best way to find this out is by comparing turnover ratios.

The bottom line is that you should take the time to learn about your funds and understand that not all funds are created equal. CNNfn says that one of the darkest secrets of the mutual fund industry is that taxes can wipe out a significant chunk of your investment returns. Neil Wolfson, a tax expert with the accounting firm KPMG, says most investors have been in the dark about mutual funds. He believes the majority of investors remain woefully uniformed about the tax implications of a fund manager's trading decisions. And not surprisingly, Joel Dickson, a Vanguard Group principal, says that while there are thou-sands of funds, only 30 or so are tax-managed. So if your fund has a high turnover ratio, you could be writing a big check to Uncle Sam.

It's very easy to determine or find the turnover ratio of a fund. If your advisor can't do that for you, you should ask yourself whether he or she is looking out for you or themselves.

Above all, make sure you know not just the fund's rate of return, but your rate of return net of taxes. What matters is not how much money the fund makes, but how much money you get to keep.

## STOP PAYING TAXES ON MONEY YOU'RE NOT SPENDING

The most important thing you can do is stop paying taxes on money you aren't spending. Of course, if you are spending your money, good for you. You've worked hard for it, so spend it and enjoy yourself. But if you aren't spending your money, don't pay taxes on it.

The best way to do this is by positioning your money in investments where taxes are handled on a deferred basis. Some investors disagree, and you might be rolling your eyes right now.

"That's a problem waiting to happen," is a common response. "I'm going to have to pay taxes on it eventually, so why not just pay now?"

Because paying now is actually more costly than deferring your taxes!

Let's say that you have a tax bill of $2,000 per year, but you've decided to defer it for 10 years. So you defer $2,000 in year one and another $2,000 in year two, and you continue to do this for 10 years. Now during this time, you continue to grow that money at 6% in a bank, stock, bond, etc. At the end of those 10 years, your deferred tax has grown to $36,000 thanks to your investments.

Of course, you still have to pay taxes on the money. You have to pay the $20,000 you deferred ($2,000 per year x 10 years). And you will have to pay tax on the $16,000 gain. Uncle Sam could conceivably take up to one-third of your $16,000 (assuming you are in the highest tax bracket). That would take $5,330 but leave you with $10,670 after tax…just by deferring!

Compare this to your grumpy old friend who said you were being a fool. He was in the same situation and decided to pay his taxes each year. He pays $2,000 in the first year, another $2,000 in

© 2012-2016 Lakes Publishing, LLC

the second year, and so on for the next 10 years. Once everything is done, your friend has paid $20,000 in taxes over the course of those 10 years…and he doesn't keep anything.

No one in their right mind wants to end up with nothing when they can end up with $10,670. So don't pay taxes on money you aren't spending.

We would all like more income and fewer taxes, and you can have your cake and eat it too if you take advantage of two provisions in the tax code.

IRS Reg 1.72–2(b) and IRS code section 72(b)(1) can help. These enable you to take advantage of exclusion ratios and can be used to create a split tax plan that will reduce taxes on your income. The exclusion ratio idea is contrary to the old idea of "spend your interest to save your principal." We've all had that ingrained in us. But in order to take advantage of these provisions, you'll have to think differently.

These provisions provide a way to arrange your affairs so that you pay 1.5% tax on your income instead of paying up to 33% in tax. They allow you to increase your income while reducing your taxes and may cut your taxes on capital gains in half. You probably aren't familiar with this, but don't you think you should be?

## UNDERSTANDING TAXES AS IT PERTAINS TO THE RETIRED PERSON

In order to understand how taxes are affecting you, it's necessary to look at your annual tax return in light of your investments. So while your accountant may handle your tax return and your advisor may handle your portfolio, these documents need to be compared to each other.

The first step is for you and your advisor to go through your tax return every year. I said your Financial Advisor should review your return with you…NOT just your Accountant. A good Financial Advisor will save you far more on taxes then your accountant can. Schedule an appointment, and sit down with him or her to review your 1040. If your advisor is on the ball, there are several areas he or she may be able to help you with.

Begin by looking at lines 8a and 8b. You will probably find income you could defer. For example, do you have income from municipal bonds? If so, it could be causing you to pay increased taxes on your Social Security. Also, look at line 9 for help with sheltering dividends. Look at line 12 if you own your own business and line 13 for help in reducing capital gains. Line 16 will help with your exclusion ratio, and line 20b will tell you how much of your Social Security is being taxed.

If you are reinvesting interest from savings bonds, annuities or the cash value on your life insurance, you won't pay federal, state or Social Security tax.

The point is that you need to fully explore all your choices for rein-vested taxable money. You should not pay taxes on money that is growing and that you aren't spending.

Of course, if you are comfortable with how much you are paying in taxes each April, don't worry about it. Some people such as Ross Perot put all of their money in municipal bonds and don't worry about taxes on social security. But the rest of us (who aren't rich) could use some help.

*© 2012-2016 Lakes Publishing, LLC*

### Tax Deferral and Annuities

Although there are a variety of tools to defer taxes, annuities are the most popular way to do so. But not all annuities are good, and you need to be cautious of insurance companies and agents when considering these products.

*Most municipal bonds aren't taxed for federal purposes, but they can be taxed for social security purposes, depending on your income. Federal bonds, on the other hand, are taxed for federal purposes and Social Security, but not for state purposes.*

Many annuity companies lure investors with a high interest rate for the first year, but lower it to sub-par levels once the interest rate renews in the second year. Like many senior investors, you may have realized this too late. Many of you opened up annuities years ago and are no longer happy with your current interest rates. You realize that other companies pay higher interest rates, but you are rightly concerned that if you move your money, you'll have to pay taxes.

But if you are in this situation, there is good news; IRS code section 1035 allows you to refinance old annuities so you can get a higher interest rate. This section allows you to move your annuity to a new company without having to pay any taxes.

Another concern is penalties. Some companies require investors to pay a surrender penalty if they transfer their money to a different annuity. Fortunately, there are a handful of companies with high interest rates that will pay your surrender penalty for you.

So if your annuity is low interest, you owe it to yourself to shop around for a better interest rate and to refinance the annuity when you find one. If you are currently receiving a low interest rate from your annuity and you don't shop, you are letting your insurance company take a higher profit off your investment. And most of us aren't so generous as to give large corporations an extra bit of our money.

Although we've discussed the benefits of tax-deferral, there is something even better – paying no tax at all! What if your insurance company agreed to pay the taxes for you upon your death? It would certainly save your children and spouse a lot of headache, not to mention money. Some annuity companies realize this, and there are a handful of companies that pay an extra 28% on your gains to cover the taxes associated with them.

### "I'm Spending My Kids' Inheritance!"

Many senior investors say, "We've done a good job providing for our kids. We sent them to a good college and gave them good values…so they're entitled to whatever is left over after taxes….but only after we're done with it ourselves!" There isn't anything wrong with that, but if you are concerned about the amount of taxes your children will pay once you are gone, just be mindful that there are companies out there that will pay them. You just need to find those companies and start investing with them.

## NOT ALL ANNUITIES ARE GOOD

But before you start moving your money around, remember this: not all annuities are good. In fact, brokers often put variable annuities inside an IRA, something you should generally avoid at all costs. FINRA is the regulatory agency that issues and revokes licenses. They also fine dealers who break the rules. In 1999 FINRA put out a Notice (# 99-35) stating that a variable annuity inside of an IRA is almost never a good thing. The notice also stressed that the person who puts money into these kinds of investments should have an extremely strong and compelling reason for doing so.

© 2012-2016 Lakes Publishing, LLC

So if a variable annuity is inside your IRA, ask your advisor why. If they can't give you a really good reason for this, you are flushing 5% to 20% of your annual return down the toilet. Just as you were with low interest rate annuities, you are simply giving away more of your hard-earned money.

Another major problem with variable annuities is the Income Benefit Riders. These promise the investor a supposed 6% or 7% guaranteed interest rate. The problem with these riders is that they are very complex. Make sure you read all the fine print or you may be in for a nasty surprise. And please, NEVER take your advisor's word for how it works. Have them show it to you in writing!

## ARE B SHARES OKAY TO OWN IN A MUTUAL FUND?

Class B shares are another problem inside mutual funds. This has become a fairly regular problem, and many people say they bought Class B shares because they were "no-load" as long as they stayed in the fund for six or seven years.

Unfortunately, that's not true. B shares are loaded with 12(b)-1 fees. These 12(b)-1 fees are dis closed inside the prospectus for B shares, but most investors overlook it or don't read the prospectus at all. So if your mutual fund has B shares, look at the prospectus. And if you're paying 12(b)-1 fees in your mutual fund, you are probably being overcharged roughly 1% a year for the six or seven years the B shares are in the fund.

Let's say that you have $85,000 in your IRA, and your spouse has $55,000 in his or her IRA. The two of you have well over $100,000 combined in your IRAs.

And if both of the IRA's have B shares, you are paying a lot of money for that privilege; it's just more money you are giving away. Why? Because owning B shares is like buying an egg from a farmer for $0.25, then coming back a week later to buy 1,000 eggs. If you return to buy that many eggs, you must really like them. Well, the farmer will appreciate the fact that you are willing to buy so many eggs at one time, so he'll probably give you a break on the price. More than likely, you'd end up paying much less than $0.25 for each egg because of the volume you are buying.

Mutual funds work the same way. Companies have to give you break points and lower your initial sales costs if you invest a certain amount of money in the fund.

Most of the time, advisors put investors into B shares rather than A shares because it means more money for the advisor. This has become such a big problem that the Securities and Exchange Commission (SEC) has said that every salesperson should disclose and keep records of available break points.

Yet the vast majority of people who own B shares do not know about break-points. If an advisor recommends B shares over A shares, but does not give any proof of how this benefits the customer, disciplinary action could be taken against the advisor. So be aware of variable annuities inside of your IRA, as well as B shares inside your mutual fund.

## WHAT TO DO WITH ALL THAT IRA AND 401(K) MONEY

Thirty years ago, the biggest asset most people in the United States owned was their house. Today, it's their IRA. And like most retired investors, you've probably accumulated quite a bit of money in your IRA. It's a great deal, but once you start pulling money out of it, you have to pay taxes on it. Of course, we'd all like to take money out of our IRA without paying taxes on it. The problem is that just isn't possible. But many people aren't aware that you can take your money out in a tax-efficient manner.

*© 2012-2016 Lakes Publishing, LLC*

Would you also like to increase the value of your IRA by 300% or more? Obviously we'd all like to do that! The catch is that this isn't for you, but your beneficiaries – it benefits your kids and grandkids.

There is a provision in the tax code that allows you to defer taxation of your IRA for up to two generations.

Let's say that at your death your spouse inherits your IRA and defers the taxes over his or her lifetime. But once your spouse dies and your children or grandkids inherit your IRA, they'll have to pay the taxes on it within one to five years. More importantly, they stand to lose up to 50% to 70% of the IRA due to taxes.

Instead of leaving your children and grandchildren with this bur-den, you could decide to create a "stretch IRA." This would allow your kids and grandkids to defer taxes on the balance of your IRA so they can create a consistent income over their lifetime.

With a stretch IRA, your beneficiaries can turn a modest account of thousands of dollars into millions of dollars by deferring taxes on it instead of paying the taxes within one to five years. And should your kids or grandkids want to accelerate the distribution or take it all out right away, they can do that as well. Or if you are worried that your 21-year-old grandson will blow it all during his first year of college, you can limit the distribution so it comes out slowly over time.

This can literally turn an IRA into millions of dollars and create a lifetime income and a family legacy while saving tens of thousands of dollars in taxes. The stretch IRA is simple to implement, but you need to put the proper paperwork in place now. So if you are interested, ask your advisor if this is appropriate for you.

By the way, 401(k)s and 403(b)s are not allowed to use this strategy. So if you have a 401(k) or 403(b), get in touch with a qualified advisor as soon as possible to explore your options.

## THE ROTH IRA

In 1997 Congress created the Roth IRA. As you probably know, the great thing about Roth IRAs is that they grow tax- free throughout your lifetime. But did you know you could extend that? If you combine a Roth IRA with a stretch IRA, it will be tax-free not only in your lifetime, but also throughout your children's and grandchildren's lives as well, if set up properly.

But there is a catch; if you convert a traditional IRA to a Roth IRA, you have to pay the conversion tax up front. When the Roth IRA first started, you were able to spread out the conversion taxes over four years – but not anymore. So if you move $100,000 from your regular IRA to your Roth IRA, you'll have to pay taxes (how much will depend on your tax bracket) and that amount will be due as soon as you move it.

But as with any problem, there is a solution. In this situation, you could utilize a little-known tax option that allows you to take a discount on the conversion of up to 59%. How? By utilizing the "Smart Asset Income Ladder" program. And while you may not have heard of this, your advisor should know how it works. Wouldn't you prefer to pay tax on only 41% of your IRA, as compared to all of it?

These kinds of tax solutions can make a big difference in your federal income tax, but you need your advisor's input and advice to determine which of these techniques will help you write a smaller check to Uncle Sam each April.

*© 2012-2016 Lakes Publishing, LLC* 

And that means your advisor should look over your tax return! If your advisor isn't aware of these techniques, you need to find one who is!

## WHY ISN'T MY ACCOUNTANT TELLING ME THIS STUFF?

A lot of people ask, "Why hasn't my CPA told me about all this?" It's a fair question and one I'd ask if I learned I could save money on taxes.

Whenever you file your taxes, be it a 1040 or other form, there are two signature lines. One is for you, and the other is for your tax preparer (not tax advisor). You are paying this individual to look over last year's information, plug in the correct numbers, do all of the math, and keep you out of trouble. You aren't paying a tax preparer for advice (although many people make the mistake of believing that they are).

SMART ASSET INCOME LADDER

- *Pulls out up to 59% of your IRA tax-free*
- *Reduces your taxes by more than half*
- *Guarantees you future income*
- *Works by using the tax code in your favor (IRS Sec. 1.401(a)(9) 6 and Sec. 54.4974-2)*

As you probably realize, tax preparers make most of their money during the months of February, March, and April. That's because it's "tax season," and they're preparing tons of tax returns. They know that the more people they file taxes for, the more money they make.

Now, imagine that it's March 20, and your preparer is swamped with clients and tax forms to complete. It's three in the morning, and they are burning the midnight oil. The preparer begins working on your 1040.

"You know what?" they say to themselves, "I think Mr. Smith could benefit from this tax-reduction strategy. But I'm not sure about all of the details, so I'd better grab a few books and do some research to make sure. It shouldn't take more than a couple of hours to figure out. If I'm still not sure, I can always go online and figure it out with some additional research."

## DO YOU REALLY THINK THEY WOULD DO THAT?

What's the likelihood of that happening? Not much. Your preparer is paid to prepare your taxes, not save you money in the process. And when time is precious during tax season, your preparer is concerned with getting your form done and moving on to the next client, not looking out for you.

Now I have nothing against accountants. In fact, I have a very good one, and I could not live without him. But I certainly don't rely on him to reduce my tax bill. It's not his job. You are responsible for lowering your tax bill, and if you need help, you should ask your financial advisor – not your tax preparer.

## WHO IS RESPONSIBLE FOR LOWERING YOUR TAXES?

If you aren't doing these things with your advisor every year, then you have to ask yourself, "why not?" Either your advisor doesn't know how to help you or he or she doesn't care. And in my book, it doesn't matter which is true. If they aren't helping me, I need to find someone who can.

Everyone is different when it comes to how much they can save in taxes. My personal record is saving a client $24,000 a year. That's $240,000 over 10 years. How great would that be?!?

That's the high end of the scale, though. Most of my clients fall in the $2,000 to $4,000 range when it comes to annual tax savings. But even so, imagine what you could do with an extra $2,000 to $4,000 per year. That's $20,000 to $40,000 in ten years. The things we are talking about are worth tens of

thousands of dollars in the long run. You could buy a new car with those savings or pay for a grandchild's college education!

Of course if you are using your tax savings, who's really paying for that car or your grandchild's college? The IRS…because it's money you would have had to pay them otherwise. So be informed and take advantage of your situation.

As we discussed in this chapter, you should recognize that you need to find a problem before it becomes a problem. You've also learned:

- Municipal bonds aren't tax-free if you are in the middle-income category and are drawing Social Security.
- About the tax problems with mutual funds – things like turnover ratio and phantom income.
- How to stretch your beneficiaries and why you should consider a painless Roth IRA.
- The strength of tax-deferral.
- About insurance companies that pay taxes for you and why you should not have variable annuities inside your IRA.

But most importantly, you've learned that if your financial advisor is not telling you about these things, it's because he or she doesn't know about them or simply doesn't care. And if you are in that situation, you need to find one who does know and who does care.

If you would like to learn more about the most current tax-saving strategies…and even have a personalized mock return prepared that shows you exactly how much YOU could save in the next 12 months…don't hesitate to contact us!

*© 2012-2016 Lakes Publishing, LLC*