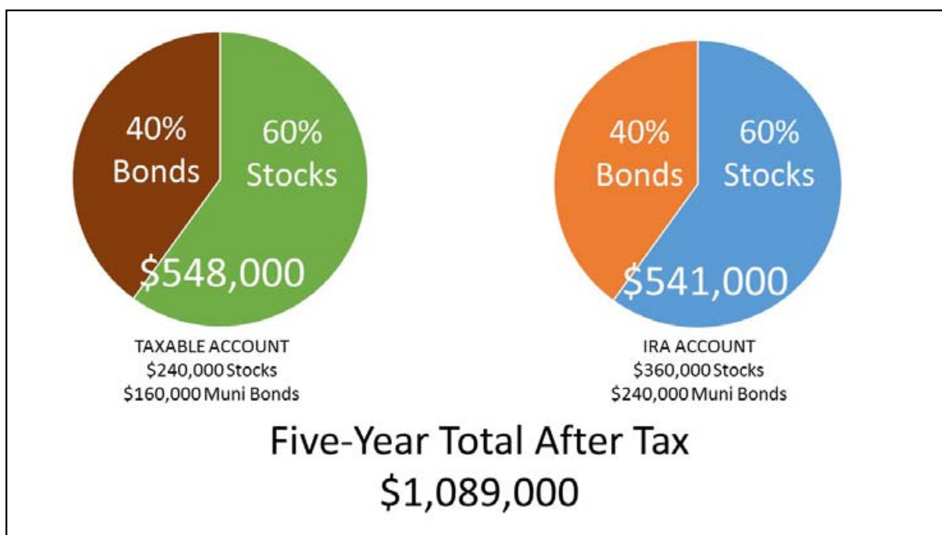
The COMPASS Chronicle

Winter 2016 *Highlighting important wealth management issues*

Optimizing A Retirement Portfolio For Taxation

Locating investments in the right type of account can make a big difference in your retirement savings and lifestyle.

Here's the story, told through an example of a hypothetical couple — Jodi and Mark — with $1 million in savings. Their tax-advantaged IRA accounts hold $360,000 in stocks and stock mutual funds, plus another $240,000 in taxable bonds. Jodi and Mark's taxable account holds $400,000, with 60% in stocks returning 10% annually in capital gains and 40% in muni bonds yielding 3.6% of income.



To keep it real, let's make these very reasonable assumptions:

- bonds yield 6% of income annually
- stocks return a 10% capital gain annually
- residents of a state with high-income tax
- combined state and federal tax rate of 40% on income
- capital gains rate of 20%

After five years, the after-tax value of the taxable account is $548,000 and the IRA's after-tax value grows to $541,000 — a total of $1,089,000.

But now look at what happens when you apply a little strategic tax planning by employing a strategy to optimize the location of your investments to minimize taxes.

Optimizing for location would place all $400,000 in the taxable account in stocks to benefit as much as possible from the 20% favorable capital gains rate. Why settle for income from the muni bonds of 3.6%, when the after tax-return on stocks annually over the long run has averaged 8%? Meanwhile, optimizing the $600,000 IRAs would

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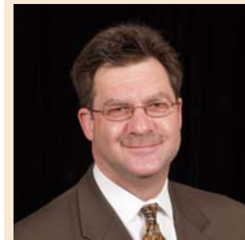
COMPASS Corner

Louis E. Conrad II, CFA®



Welcome to the latest iteration of ***The COMPASS Chronicle***. This newsletter, which we expect will highlight investment and financial planning issues relevant to your life, will be sent to you automatically each quarter. Feel free to forward it to your family or friends who may have interest. If they would like to be added to our e-mail distribution list, ask them to forward an e-mail to me at lconrad@compassinvest.com and have them ask to "Subscribe" to our newsletter—I will ensure they are added to our distribution list.

The COMPASS Corner will be our firm's place to update you on COMPASS' activities, capital market or economic summaries, or other relevant issues potentially impacting your financial life. We encourage your feedback, including issues you would like addressed in this newsletter. We have partnered with a firm with longstanding experience in providing insightful articles to advisors for the enrichment of their clients. This quarter's ***COMPASS Chronicle*** includes articles on asset location, tax implications of investing, Social Security, and custodial versus Section 529 accounts.

We hope you enjoy the latest ***Chronicle***.

What To Know About Social Security

The Social Security Administration (SSA) recently announced that there will be no increase in retiree benefits in 2016 because of the low inflation rate. Cost-of-living adjustments (COLAs), which are based on a consumer price index for urban wage-earners, have been standard fare and most retirees expect them. In fact, this is only the third time without a yearly increase in Social Security retirement benefits since COLAs were instituted in 1975. (The other two occurred in 2010 and 2011.)

It may be small consolation, but the Social Security wage base for payroll taxes also won't go up, remaining at $118,500 in 2016. This means the first $118,500 of wages you earn in 2016 is subject to a 6.2% tax (or twice that if you're self-employed). There's also a tax for Medicare of 1.45% on all earnings.

Furthermore, the SSA has announced that the limits under the "earnings test" (the amount you can earn from working without forfeiting Social Security benefits) also are unchanged.

Did this "freeze" for 2016 catch you by surprise? If so, you're not alone. People from all walks of life, including those who already have retired, often don't fully understand the rules for Social Security or are unaware of how complex the rules are. Use this quiz to test your personal knowledge of the subject:

1) The earliest age you can begin to receive Social Security retiree benefits is:

a) age 59½.
b) age 62.
c) age 65.
d) age 70.

2) The amount you will receive if you opt for early retirement may be reduced by as much as _____ for someone born in 1960 or later.

a) 5%
b) 10%
c) 20%
d) 30%

3) To get the maximum amount of Social Security benefits, you need to wait until ______ to begin receiving benefits.

a) age 59½
b) age 62
c) age 65
d) age 70

4) Spousal benefits are available to an unmarried ex-spouse if he or she was married to the beneficiary for at least:

a) 3 years.
b) 5 years.
c) 10 years.
d) 25 years.

5) Social Security retiree benefits are partially taxable if your benefits exceed ________ if you're a single tax filer and ________ if you're a joint filer.)

a) $10,000/$25,000
b) $25,000/$32,000
c) $50,000/$100,000
d) $200,000/$250,000

6) The age when a Baby Boomer born between 1943 and 1954 is able to receive full retirement benefits is:

a) age 62.
b) age 65.
c) age 66.
d) age 70.

7) For 2016, the maximum amount you're allowed to earn in the year you reach full retirement age—but before the month of your birthday—without forfeiting any benefits is:

a) $15,480.
b) $26,480.
c) $41,880
d) $55,880.

Answers: 1-b; 2-d; 3-d; 4-c; 5-b; 6-c; 7-c

Be Aware Of Your Tax Surroundings

When you trade stocks, bonds, or other capital assets, it makes sense to focus on the "bottom line"—whether you'll make or lose money, and how big your profit or loss may be. But what you're doing has tax consequences, too, and you need to be aware of what they are. And sometimes the likely tax ramifications of a transaction could influence whether you go ahead with it.

For simplicity, this discussion of tax-aware investing will look only at federal taxes, although there may be similar results on the state level.

Start with the basic premise that you can "net" any capital gains and losses you realize during the year, with losses subtracted from your gains. Any excess loss can be used to offset up to $3,000 of ordinary income, which is taxed at rates as high as 39.6%. If you have additional losses, you can carry them over to the following year.

Long-term capital gains are taxed at a maximum rate of 15%, or a top rate of 20% if you're in the top ordinary income tax bracket of 39.6%. To the extent that any of your long-term capital gains are taxed in the two lowest income tax brackets of 10% and 15%, the tax rate is 0%.

That can be especially beneficial to a tax-savvy investor. Suppose you realize a net long-term capital gain of $25,000 from a securities transaction this year. If you have $15,000 of room to spare before you cross into the 25% tax bracket for ordinary income, there will be zero tax on the first $15,000 of gain. The remaining $10,000 then will be taxed at the 15% rate for long-term capital gains. In other words, you pocket $25,000 of gain and pay a total capital gains tax of only $1,500!

Short-term capital gains, meanwhile, are taxed at ordinary income rates. This could have an impact on how long you hold securities, perhaps convincing you to delay taking a profit until it qualifies as

7 Top Tax Ideas To Use In A Declining Market

The brief 1,000-plus point plunge of the Dow Jones Industrial Average on August 24, 2015, rattled even the most optimistic investors. Whether the meltdown was part of a temporary correction or a harbinger of a bear market, it did serve as a reminder of tax moves that could be helpful when markets decline. Here are seven tax techniques you might consider:

1. Roth conversions. When the value of the assets in your IRAs falls, it may be a good time to convert part or all of the account to a Roth IRA. You'll pay income tax on the amount you convert—and when the account value drops, the amount of tax you owe also will be reduced. And paying tax now on the conversion will allow you to avoid paying it later, when you make withdrawals from a traditional IRA. Future payouts from a Roth will be tax-free if they're made during retirement and according to government rules.

2. Recharacterizations. But what if you recently converted assets in a traditional IRA to a Roth—and paid more in taxes than you would when stock prices are lower? The tax law allows you to "undo" the conversion if it suits your needs. For a conversion that took place in 2015, you have until the tax return due date for the year plus any extensions—so, until October 15, 2016—to recharacterize the IRA. It will be as if the conversion never happened.

3. Loss harvesting. If you're currently holding stocks that are worth less than you paid for them, this could be an optimal time to sell. The resulting capital losses can offset capital gains plus up to $3,000 of ordinary income this year. This could be especially beneficial if you can use the losses to offset short-term gains taxed at ordinary income rates of up to 39.6%. Short-term gains result from sales of assets you've held a year or less. If you have more than $3,000 of additional losses you can carry them over to 2016.

4. Retirement plan contributions. If the stock market is floundering, you can find some relative comfort in your qualified retirement plans. Adding to your 401(k) or other plan, perhaps a pension, or a profit-sharing plan, can help beef up your savings for retirement, regardless of the ups and downs of the market. Since there's no "gain" or "loss" until you actually take distributions, the extra amounts contributed can continue to grow on a tax-deferred basis. Along the same lines, you might benefit from contributions to an IRA (traditional or Roth) to supplement the qualified plans.

5. Gifts of securities. Assuming you don't need the capital losses this year, you might decide to give depressed assets to family members. Under the annual gift tax exclusion, you can give away securities valued up to $14,000 per recipient ($28,000 for a joint gift by a married couple) without any gift tax consequences. That will reduce the size of your taxable estate. And giving away stock when the price is down lets you transfer more shares—whose prices may recover later.

6. Funding a trust. This strategy, too, lets you take advantage of lower asset prices. A grantor retained annuity trust (GRAT) can help you transfer wealth, often a business interest, to younger beneficiaries. With a GRAT, you transfer the assets into the trust but still can take annual annuity payments for a specified number of years. When the term of the GRAT ends, the remainder is distributed to the beneficiaries. And if the assets you transfer are worth less than they had been, any gift tax liability will be reduced.

7. Using an alternative date for the valuation of inherited assets. This postmortem strategy could provide valuable savings for your family. Normally, the value of the assets in your estate for estate tax purposes is established on the day you die. However, an executor can elect to calculate the value of your estate six months after your death. If stocks or other assets have lost value, any estate tax paid by your heirs will be lower, too. Keep in mind, though, that alternate valuation is an all-or-nothing proposition. It can't be used for certain assets in the estate and not for others.

These and other tax moves could help you reduce the impact of a market decline and perhaps turn it to your advantage. ●

a long-term gain. Upper-income investors also may have to pay a 3.8% surtax on some investment income.

"Qualified" dividends from U.S. companies benefit from the same preferential tax rates as long-term capital gains. To qualify, you must have held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date (that is, the first date following the declaration of a dividend on which the buyer of a stock is not entitled to receive the next dividend payment).

Other types of investments, too, may be eligible for favorable tax treatment. For instance, while payouts from employer-sponsored retirement plans and IRAs are taxed as ordinary income, qualified distributions from Roth IRAs are 100% tax-free after five years. The tax law includes other statutory benefits that may apply to real estate, annuities, master limited partnerships, and life insurance.

Tax aspects are a critical part of your investment decisions. If you can learn how they work and what the potential tax impact is, you may be able to keep more of your investing profits. We can help you determine how to proceed. ●

Compare Minor's Account To 529 Plan

Until the Section 529 college savings plan came along, parents looking ahead to the high cost of college for their children often set up accounts under their states' Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA). But the broad benefits of 529 plans have made them more popular than UGMAs and UTMAs in recent years. Here's how the two saving vehicles compare:

UGMA/UTMA accounts: These are custodial accounts to which you contribute money for a minor's benefit. As the custodian, you control the investments until the child reaches age 18 or 21, depending on the laws of your state.

However, for tax purposes, any earnings on account assets are taxed to your children at their lower tax rates. For 2016, the first $1,050 of earnings in a custodial account is tax-free and the next $1,050 is taxed at the child's rate. But earnings beyond $2,100 are generally subject to the so-called kiddie tax—they're taxed at the parents' top rate. And whether you pay or your child pays that tax, it creates an annual drain on the account during the years you're trying to build up funds for college.

Section 529 plans: With this type of state-sponsored plan, you contribute to an account for which you name your child as beneficiary. Then you're in charge of how the money is invested (though only among the options the plan offers, and the ability to switch investments is limited). Unlike in a custodial account, earnings from investments aren't taxed while they're accumulating. And distributions from the plan that go to pay qualified college expenses, such as tuition, also aren't taxed.

Those provisions give 529 plans a dramatic advantage over a custodial account. There aren't any kiddie tax complications with a 529 because the growth in the account you've set up for your child isn't taxed at all during the years leading up to college. And whereas you may owe capital gains tax when you sell investments in a custodial account to pay college expenses, that doesn't happen when you take money from a 529 to pay for college.

In addition, if your kids have a custodial account, they get control of the money once they reach the age of majority in your state—and they can use it any way they want, not just for college. That doesn't happen with a Section 529 plan—you stay in control of the account regardless of the age of the beneficiary.

A final disadvantage of a custodial account is that it may hurt a student's eligibility for federal financial aid because it counts as that student's asset, not that of the parents. Section 529 plans, in contrast, are treated as if they belong to the parents and aren't likely to affect financial aid eligibility.

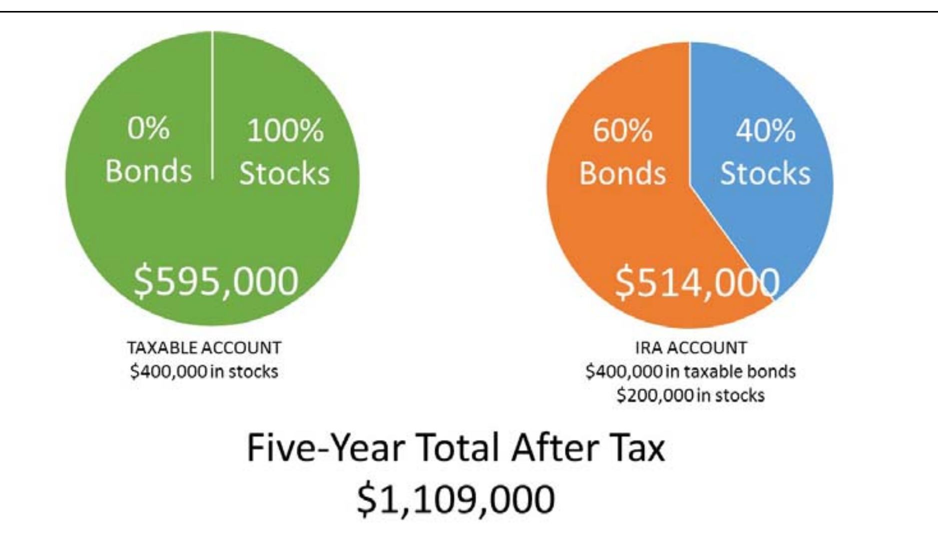
So while there may be situations in which a custodial account makes sense in saving for college, in most cases a 529 plan will work better. ●

Optimizing A Retirement Portfolio

(Continued from page 1)

mean holding $400,000 in bonds and $200,000 in stocks. Instead of a 60% stock and 40% bond allocation, the IRA would hold the reverse — 40% in stocks and 60% in bonds.

The bottom line: $1,109,000 expected value on the total portfolio after five years versus $1,089,000. Getting an extra 2% — $20,000 — over five years on a $1-million portfolio may seem insignificant, but it compounds without being taxed every year in the IRA. After 10 or 20 years, tax-advantaged compounding becomes so powerful it prompted Albert Einstein to say, "Compound interest is the eighth wonder of the world."



Because of the long-term nature of this strategy, getting started on the right course soon is wise. If you have questions about tax optimization, please contact us. ●

COMPASS Wealth Management 290 Baker Avenue, Suite N101, Concord, MA 01742-2193 P (978) 254-7040 F (978) 254-7039 www.compassinvest.com

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