The COMPASS Chronicle

Fall 2017 *Highlighting important wealth management issues*

Finding The Balance For Retirement Draw-Downs

Victor and Jane Muratti, a computer analyst and schoolteacher married for more than 30 years, are nearing retirement. Over the years, they have accumulated a mosaic of investments, including stocks, corporate and municipal bonds, mutual funds, exchange-traded funds (ETFs), annuities, real estate, and master limited partnerships (MLPs). Some of these investments are in taxable accounts while others are in tax-deferred retirement plans and traditional and Roth IRAs.

Once they retire, the Murattis will begin drawing income from these various accounts, and after they reach age 70½, they'll have to start taking required minimum distributions (RMDs) from their retirement plans and IRAs. But they don't have a clue about the best way to create their retirement "paychecks."

It's a common situation and the circumstances will vary for every person or couple. However, one typical objective is to minimize federal income tax from investment transactions, while preserving as much wealth as you can for a lengthy retirement.

One way to do that is by paying attention to tax brackets. Income taxes are based on a graduated seven-bracket system, with different tax rates for each bracket. The more of your income that falls into lower brackets—and so is taxed at lower rates—the better. And to the extent that you can control how much income you receive, you could try to take just enough to fill up your current bracket without moving into the next, higher one. You can use this tax bracket management strategy throughout retirement.

But to benefit, you'll need to learn the basics for three different types of accounts you're likely to tap during retirement.

1. Taxable accounts: This category includes all of the investments you hold outside of retirement plans. You may have stocks, bonds, mutual funds and ETFs, as well as interest-bearing savings accounts and certificates of deposit (CDs). If you sell any of these at a gain, your profit will generally be taxed at the favorable rate for long-term capital gains—that is, gains on investments you've held for a year or more. The tax rate for long-term gains is 15%, or 20% if your income puts you in the top tax bracket for ordinary income. Most dividend income from stocks is also taxed at 15% or 20%. But interest from bonds and other investments is likely to be taxed at the higher rates for ordinary income.

2. Tax-deferred accounts: Within tax-deferred accounts such as 401(k) plans and traditional IRAs, capital

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COMPASS Corner

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Stocks continued to march higher, with U.S. stocks capping their eighth consecutive quarter of gains, with the major averages ending at or near all-time highs. The Russell 3000 Index, a broad measure of U.S. stocks, generated a return of 4.6% during the third quarter and 13.9% for the year-to-date period.

International stocks performed marginally better than U.S. stocks during the quarter, supported by a weaker U.S. dollar. The MSCI EAFE Index, which represents stocks of the non-U.S. developed world, gained 5.4% for the quarter and 20.0% through the first nine months of the year.

Like stocks, bonds rallied during the quarter until early September, when they reversed course in response to rising interest rates. However, rates were little changed overall for the quarter, leading to a lackluster return for the Bloomberg Barclays U.S. Aggregate Bond Index of 0.9% during the third quarter, though the total return was 3.1% over the first three quarters.

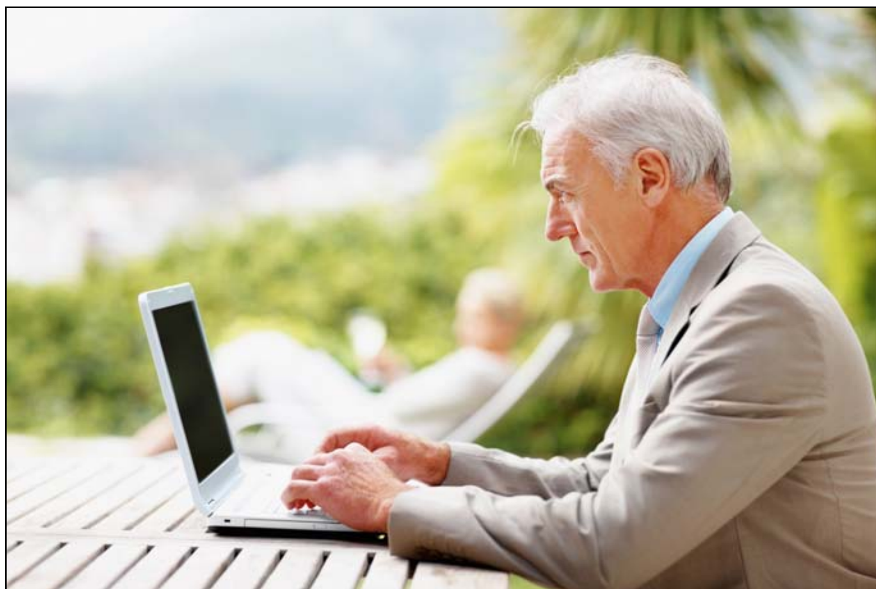
COMPASS continues to expect that interest rates are on an upward trajectory due to the Federal Reserve's actions, the prospects for foreign central banks to be less accommodating, continued improvement in the U.S. economy, and tax reform efforts in the U.S. Further, COMPASS believes that the U.S. stock market is susceptible to a 5% - 10% pullback given the prospect for higher interest rates, decelerating earnings growth, higher stock valuations, and heightened geopolitical concerns.

Lending Money? Watch Your Tax Step

Doug Burnside is in a quandary. His daughter, Megan, needs money to get a new business venture going. But Doug can't afford to give her the money outright and she has had trouble getting a loan from a bank.

What can be done? One idea is for Doug to lend his daughter the cash. Megan can repay Doug, with interest, if the business succeeds. Everyone wins.

But this kind of intra-family loan brings several potential tax pitfalls. As long as the loan is for $10,000 or less, there won't be a problem. However, if the borrowed amount is larger and he doesn't charge the going rate of interest, the IRS will "impute" interest for him, based on its own assumptions. He'll end up being treated as if he had charged his daughter interest, even though he hadn't, and he'll owe tax on that "phantom income" that he didn't receive.



In such cases, if the loan is for $100,000 or less, the interest you will be considered to have received annually for tax purposes is limited to the amount of your child's net investment income for the year. And if that amount doesn't exceed $1,000, you can avoid taxable interest income on the intra-family loan. But the IRS may still intercede if it suspects that you're trying to dodge the tax liability.

How do you figure out what the "going rate" for interest is? It depends on several factors, including the type of loan, its length, and the interest rates in your local area. You might be able to charge slightly less than a local bank would get, but you can't go overboard.

What happens if Megan's business fails and she can't pay Doug back? The IRS could determine that the "loan" was always meant to be a gift. To avoid that problem, it's best to have an attorney draft a formal loan document. It should include the usual terms that would be found in a bank loan. For instance, the document will usually indicate:

- The amount of the loan;
- The time allowed for repayment;
- The interest rate structure;
- A description of the collateral securing the loan.

Finally, have the loan document witnessed and notarized. This is the best proof you can have if the IRS ever challenges the deal. Also, keep records showing repayments to demonstrate that the arrangement is a bona fide loan. ●

6 Ways To Close The Retirement Gap

According to a recent article in *The Washington Post*, 71% of Americans aren't saving enough for retirement. If you're in this predicament, what can you do to close the gap? Here are six practical suggestions.

1. Bolster your 401(k). Much as it may pain you, try to allocate more of your paycheck to your 401(k) account or similar retirement plan. In addition, to supplement an employer-based plan, you might contribute to an IRA. The tax law allows generous contribution limits. Contributions grow and compound tax-deferred until you're ready to make withdrawals.

2. Invest wisely. If you can, investing additional money outside your retirement accounts can be very helpful. For taxable accounts, you may want to emphasize assets that don't produce a lot of taxable income in the form of mutual fund distributions, stock dividends, and bond interest. Although the fundamental principles of asset allocation and diversification aren't foolproof—there are no guarantees against loss of principal, especially in a declining market—they have performed well historically.

3. Don't squander your tax refund. The IRS says that the average tax refund received in 2017 (for the 2016 tax year) exceeded $3,000. What did you do with your refund? Instead of spending most or all of it each year, you might plow part of it back into savings earmarked for your retirement years. This money, along with some of your periodic pay raises, can help you fund your 401(k), IRA, and taxable accounts.

4. Get your tax money faster. Of course, money that's refunded to you after you file your taxes was really yours all along, and adjusting your withholding can reduce the size of your interest-free loan to the government. For example, rather than getting a $5,200 refund, you could take home an

5 Estate Planning Steps To Benefit Your Elders

Estate planning normally involves strategies to preserve wealth for a family's younger generation. But it may also involve elderly relatives—your parents and in-laws or maybe an aunt or an uncle—who could use your assistance. Indeed, this older generation might need your help even more than your offspring who are already making their way in the world.

Consider these five steps to help your older relatives.

1. Have "the talk." As difficult as it can be to sit down with a parent to talk about money and end-of-life decision-making, there's really no alternative to having a candid discussion of these sensitive matters. Your mom and dad may not like what you have to say, but if you start by really listening, giving them the opportunity to provide their point of view, it could launch a productive discussion. Try to address tough issues such as the possibility of relocating to an assisted-living facility or a nursing home, and don't be surprised if things get heated and emotional. Including other family members, such as your siblings, in this discussion will also be helpful, and whenever possible, have the family meetings in person rather than over the phone.

2. Create a contact list. You've probably already done this for yourself, but compiling all of the names, addresses, phone numbers, and email addresses of crucial contacts for your older relatives can be particularly crucial. These could include financial advisors, attorneys, accountants, insurance agents, physicians, and dentists. These days, creating a digital version of the list and storing it on multiple computers makes the most sense.

3. Gather financial information. Along with a contact list, information about the relative's financial affairs and investment holdings is also essential. You'll want to know about bank and investment accounts, 401(k) or other retirement plan accounts and IRAs, life insurance policies, etc. Note current balances, account numbers, passwords, and information on Social Security benefits. You may find out that your relative has more assets than you'd thought. Use this information to formulate a plan for the future.

4. Create the necessary documents. Once everyone agrees on how to move forward, you may need to complement a will or other existing legal documents with new ones. And those your relative has may need to be revised or updated. Such documents may include:

- A will: The centerpiece of an estate plan controls how most worldly possessions—a house, cars, jewelry—will be distributed. A will also specifies an executor of the estate. This might be you, another relative, or a professional you trust.
- Power of attorney: This document authorizes someone to act on behalf of the elderly person. The most common version is a durable power of attorney that will remain in effect if the person is incapacitated. This is a vital component of most estate plans.
- Living trust: A living trust can serve as a supplement to a will. The assets transferred to a living trust don't have to go through the probate process that may be required for possessions transferred through a will and that can be drawn out and expensive. In addition, assets in a living trust are shielded from public inspection.
- Living will/health care directives: These documents provide guidance for end-of-life decisions. You'll want to make sure your relative's doctors and others also have copies so they can act according to your loved one's wishes.

Finally, don't forget about beneficiary designations for retirement plans, IRAs, and life insurance policies—they supersede provisions in a will and are important to keep up to date.

5. Look for ways to minimize estate and gift taxes. Assets transferred to relatives or friends are shielded from federal estate and gift taxes both by unlimited marital deduction for gifts to spouses and a unified estate and gift tax exemption of $5.49 million in 2017 covering transfers to anyone who's not a spouse. Your older relative can also make yearly gifts of as much as $14,000 to multiple recipients.

Estate planning for an elderly relative will inevitably be intertwined with your own plan, so don't do things in a vacuum. Your professional financial advisor can steer you in the right direction. ●

additional $100 each week. It's easy to fill out a new W-4 for your employer.

5. Bank the raise. Salary increases may be needed to help you keep up with inflation. But to the extent you can, set aside some of your raise. Again, that could go to increase your 401(k) contributions. If you get a 3% raise, say, you might use a third of it to boost your salary deferral by a percentage point—maybe from 12% of your salary to 13%. Some of the money might also go to bolster the emergency fund that's there to tide you over if you have a big expense or lose your job. Year-end bonuses can be helpful in a similar way.

6. Reduce monthly expenses. Finally, don't assume that your monthly budget is fixed in stone. If you take time to examine how and where you're spending your money, you might find some expenses that could be pared back almost painlessly. Costs for cable television, mobile phones, and other electronics can be good candidates for reductions, and you might also be able to reduce dining expenses.

These odds and ends add up over time and can help you come from behind to achieve real retirement security. ●

Five Steps When You Inherit Assets

During the next 30 years or so, an estimated $30 trillion is expected to change hands, and many offspring of older Baby Boomers may inherit a small fortune. Here are five practical suggestions for handling the windfall:

1. Give yourself time to grieve. If you're like most people, the loss of a loved one will come at an emotional cost. So you're probably not going to run out and buy a luxury car or book a cruise the day after the funeral. Allow yourself enough time for your grief to pass before you make any major decisions. Don't let your heart overrule your head.

2. Consider the limitations. Just because you've come into some money doesn't necessarily mean you'll be living on Easy Street. So try to resist the impulse to splurge on items you still can't afford. You might consider using some of the money for a one-time "treat" for your family and use the rest to invest for long-term goals.

3. Pay down debt. If you owe a lot of money, this could be a good opportunity to pay off some of your obligations. While you don't have to rid yourself of *all* of your debt —you might decide to keep your mortgage and perhaps a car loan—it could make sense to retire credit card and other debt that has high interest rates.

4. Set goals. In considering how to use your windfall, you might divide your objectives into short-, medium-, and long-term goals. For instance, in the short term you may decide to move to a bigger home. A medium-term goal might be to save money for a child's college education through a Section 529 plan. And a long-term objective for many is to secure a comfortable lifestyle in retirement.

5. Create an estate plan. If you haven't done this already, your windfall could provide an excellent opportunity to prepare for the eventual transfer of your own wealth, including the assets you've just inherited, to other family members. You might decide to establish a trust for the benefit of minors or make other arrangements to help ensure financial security for a surviving spouse or grandchildren.

Fortunately, you don't have to do all this on your own. With the help of experienced professionals, you can develop a plan that makes sense. Don't hesitate to contact us for assistance. ●

Retirement Draw-Downs

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gains and income from dividends and interest all can accumulate without being taxed. But once you start taking money out of these accounts during retirement, all or most of your withdrawals will be taxed as ordinary income. And when RMDs come along, some of the money *must* come out every year.

One kind of tax-deferred investment—annuities—may help you minimize taxes by postponing payouts until your income is lower during retirement. Deferred compensation from your company could offer similar tax benefits.

3. Tax-free accounts: Of course, no taxes are better than low taxes, and a Roth IRA may give you retirement income that isn't taxed at all. With a Roth IRA that you've had for at least five years, withdrawals after age 59½ are completely tax-free. Meanwhile, although interest income from most bonds is taxed at ordinary income rates, income from municipal bonds or municipal bond funds can be tax-exempt. These bonds could be a valuable part of your retirement portfolio.

When considering which account to draw from and in what order, a common strategy is to take RMDs first—because you must make those withdrawals—then tap your taxable accounts next, leaving assets in tax-deferred accounts to grow without being eroded by taxes for as long as possible. Finally, make tax-free withdrawals from your Roth IRA, which offers the additional advantage of not requiring distributions during your lifetime.

In addition, to the extent you can, you might practice tax bracket management, capping your taxable income at a level that will let you avoid moving into a higher bracket. So that even if you can't avoid taxes entirely during retirement, you may be able to keep them under control. ●

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