

Tax Strategies for Retirees

Nothing in life is certain except death and taxes. – Benjamin Franklin

Topical Education for Today's Investor

INCOME TAXES

That saying still rings true roughly 300 years after the former statesman coined it. Yet, by formulating a tax-efficient investment and distribution strategy, retirees may keep more of their hard-earned assets for themselves and their heirs. Here are a few suggestions for effective money management during your later years.



Less Taxing Investments

Municipal bonds, or “munis,” have long been appreciated by retirees seeking a haven from taxes and stock market volatility. In general, the interest paid on municipal bonds is exempt from federal taxes and sometimes state and local taxes as well (see table).¹ The higher your tax bracket, the more you may benefit from investing in munis.

Also, speak with your financial advisor about tax-managed mutual funds or investment accounts. Managers of these funds pursue tax efficiency by employing a number of strategies. For instance, they might limit the number of times they trade investments within a fund or sell securities at a loss to offset portfolio gains.

It's also important to review which types of securities are held in taxable versus tax-deferred accounts. Why? Because in 2003, Congress reduced the maximum federal tax rate on some dividend-producing

investments and long-term capital gains to 15%. In light of these changes, many financial experts recommend keeping real estate investment trusts (REITs), high-yield bonds, and high-turnover stock mutual funds in tax-deferred accounts. Low-turnover stock funds, municipal bonds, and growth or value stocks may be more appropriate for taxable accounts.

The Tax-Exempt Advantage: When Less May Yield More

Would a tax-free bond be a better investment for you than a taxable bond? Compare the yields to see. For instance, if you were in the 25% federal tax bracket, a taxable bond would need to earn a yield of 6.67% to equal a 5% tax-exempt municipal bond yield.

The yields shown above are for illustrative purposes only and are not intended to reflect the actual yields of any investment.

Federal Tax Rate	15%	25%	28%	33%	35%
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Tax-Exempt Rate	Taxable-Equivalent Yield				
4%	4.71%	5.33%	5.56%	5.97%	6.15%
5%	5.88%	6.67%	6.94%	7.46%	7.69%
6%	7.06%	8%	8.33%	8.96%	9.23%
7%	8.24%	9.33%	9.72%	10.45%	10.77%
8%	9.41%	10.67%	11.11%	11.94%	12.31%

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Which Securities to Tap First?

Another major decision facing retirees is when to liquidate various types of assets. The advantage of holding on to tax-deferred investments is that they compound on a before-tax basis and therefore have greater earning potential than their taxable counterparts.

On the other hand, you'll need to consider that qualified withdrawals from tax-deferred investments are taxed at ordinary federal income tax rates of up to 35%, while distributions — in the form of capital gains or dividends — from investments in taxable accounts are taxed at a maximum 15%. (Capital gains on investments held for less than a year are taxed at regular income tax rates.)

For this reason, it's beneficial to hold securities in taxable accounts long enough to qualify for the 15% tax rate. And, when choosing between tapping capital gains versus dividends, long-term capital gains are more attractive from an estate planning perspective because you get a step-up in basis on appreciated assets at death.

It also makes sense to take a long view with regard to tapping tax-deferred accounts. Keep in mind, however, the deadline for taking annual **required minimum distributions (RMDs)**.

The Ins and Outs of RMDs

The IRS mandates that you begin taking an annual RMD from Traditional IRAs and employer-sponsored retirement plans after you reach age 70 1/2. The premise behind the RMD rule is simple — the longer you are expected to live, the less the IRS requires you to withdraw (and pay taxes on) each year.

RMDs are now based on a uniform table, which takes into consideration the participant's and beneficiary's lifetimes, based on the participant's age. Failure to take the RMD can result in a tax penalty equal to 50% of the required amount. **TIP:** If you'll be pushed into a higher tax bracket at age 70 1/2 due to the RMD rule, it may pay to begin taking withdrawals during your sixties.

Unlike Traditional IRAs, Roth IRAs do not require you to begin taking distributions by age 70^{1/2}.² In fact, you're never required to take distributions from your Roth IRA, and qualified withdrawals are tax free.² For this reason, you may wish to liquidate investments in a Roth IRA after you've exhausted other sources of income. Be aware, however, that your beneficiaries will be required to take RMDs after your death.

Estate Planning and Gifting

There are various ways to make the tax payments on your assets easier for heirs to handle. Careful selection of beneficiaries of your money accounts is one example. If you do not name a beneficiary, your assets could end up in probate, and your beneficiaries could be taking distributions faster than they expected. In most cases spousal beneficiaries are ideal, because they have several options that aren't available to other beneficiaries, including the marital deduction for the federal estate tax, and the ability to transfer plan assets — in most cases — into a Rollover IRA. Non-spousal beneficiaries may be able to roll over certain accounts, if the terms of the account permit that option.

Also consider transferring assets into an irrevocable trust if you're close to the threshold for owing estate taxes (in 2007, the taxable amount is \$2 million). Assets in this type of arrangement are passed on free of estate taxes, saving heirs thousands of dollars.

Finally, if you have a taxable estate, you can give up to \$12,000 per individual (\$24,000 per married couple) each year to anyone tax free. Also, consider making gifts to children or grandchildren who are not subject to the "kiddie tax" as their income may be taxed at much lower tax rates than those that apply to adults. **TIP:** Some people choose to transfer appreciated securities to custodial accounts (UTMAs and UGMAs) to help save for a grandchild's higher education expenses.

Strategies for making the most of your money and reducing taxes are complex. Your best recourse? Plan ahead and consider meeting with a competent tax advisor, an estate attorney, and your financial advisor to help you sort through your options and to build a plan designed to help you achieve your specific goals and dreams.

Points to Remember

1. Formulating a tax-efficient investment and distribution strategy may allow you to keep more assets for you and your heirs.
2. Ask your financial advisor about tax-efficient investments, such as municipal bonds and tax-managed mutual funds, to help reduce exposure to taxes.
3. Tax-deferred investments compound on a before-tax basis and therefore have greater earning potential than their taxable counterparts. However, qualified withdrawals from tax-deferred investments are taxed at income tax rates up to 35%, whereas distributions from taxable investments held for more than 12 months are taxed at a maximum 15%.
4. You must begin taking an annual amount of money (known as a required minimum distribution) from some tax-deferred accounts after you reach age 70^{1/2}.
5. To make the most of your money while you're alive — and to maximize the amount you'll pass along to your heirs — discuss with your financial advisor how your assets fit into a comprehensive estate plan.

For more information, please contact your financial advisor.

Important Additional Notes

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1 Capital gains from municipal bonds are taxable and may be subject to the alternative minimum tax.

2 Withdrawals prior to age 70½ are subject to a 10% penalty.

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