Investor Insights & Outlook

Investment Updates For Mature Investors

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Don’t Pay Tax Twice

Reinvestment can be a crucial component of the wealth accumulation process, as the reinvested amount compounds and grows over time. Yet if you are reinvesting dividends and capital gains (“distributions”) in funds you hold in your taxable account, it can be important to ensure that you're not paying more tax than necessary. You pay tax on those distributions in the year in which you receive them. But if you don’t keep good records, you could end up paying tax on those distributions again when you sell. For example, say you bought 1,000 shares of a fund for your taxable account at the end of 2011; you paid $18 per share for a total of $18,000. In 2012, with the share price still at $18, the fund made a dividend distribution of $0.50 per share, or $500 for your 1,000 shares. You'd owe tax on the $500 on your 2012 taxes, whether you reinvested the money or took the cash in hand. (The taxes would be deferred if you held the fund in a tax-sheltered account). If you reinvested the money in the fund, you’d now own 1,027.78 shares: your original 1,000 plus the nearly 28 additional shares that you were able to buy (at $18) with the $500 dividend distribution. If you sell now, with the fund's net asset value at $20, you’d think you’d owe taxes on your $2,555.56 profit ($20,555.56 minus $18,000), right? Wrong. You would only owe taxes on $2,055.56 ($20,555.56 minus $18,000 minus $500). Otherwise, the $500 dividends would be taxed twice.

Investments are subject to risk of principal and risk of loss. Dividends are not guaranteed. Retirement accounts are tax-deferred vehicles designed for retirement savings. Any withdrawals of earnings will be subject to ordinary income tax and, if taken prior to age 59½, may be subject to a 10% federal tax penalty. This should not be considered tax or financial planning advice. Please consult a tax and/or financial professional for advice specific to your individual circumstances.

Advisor Corner

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Required Minimum Distribution (RMD) Tips and Traps

The tax-deferred compounding you get via an IRA or a company retirement plan enables you to grow your savings without having to fork over taxes on your investment earnings year in and year out. However, at some point, required minimum distributions, or RMDs, will take effect. All retirees must begin taking RMDs from their tax-deferred retirement plans by April 1st of the year following the year in which they turn age 70 1/2. They must then continue to take distributions by December 31st of each year thereafter. Roth IRAs aren't subject to RMDs. However, you exert more control than you might think over the timing of your RMDs, as well as over which accounts you tap. Here are some tips for getting the most out of your RMDs, as well as some traps to avoid.

Do

1. Even though you must calculate your RMD amounts for each of your traditional IRAs, you can draw your RMD from the investment that's most advantageous for you. If you've assessed your asset allocation and determined it's time to rebalance, take your RMD from the IRAs that hold assets where you need to lighten up.

2. Rather than taking your whole distribution at year-end, consider spacing your distributions throughout the calendar year to obtain a range of sale prices for your longer-term assets.

3. Consider "bucketing" your IRA and retirement-plan assets. That means dividing assets into cash or cash-like accounts to help address RMD and other income needs, intermediate-term assets (such as bonds) that are next in line for distributions, and long-term assets.

4. Put your distributions on autopilot to avoid the last-minute rush to execute trades (or worse, to avoid missing the deadline altogether). If you go the autopilot route, be sure to maintain cash assets in your accounts to avoid having your fund company or brokerage firm sell a long-term asset that you would have preferred to hold.

5. Coach elderly parents on taking their RMDs.

Don't

1. Miss the deadline. You'll owe a tax penalty equal to 50% of the distribution amount you should have taken but didn't, as well as the taxes that are due on any retirement-plan distribution.

2. Pay a tax penalty without stating your case first. The IRS' website indicates that the penalty will be waived if "the shortfall in distributions was due to reasonable error and that reasonable steps are being taken to remedy the shortfall." If you've missed a distribution or didn't take as much of an RMD as you should have, you'll need to fill out an IRS form. You'll also have to submit a letter detailing why you had a shortfall in your distribution and what you're doing to remedy it.

3. Spend your RMDs right away unless you've analyzed your retirement plan's viability and determined that you can afford to splurge.

4. Plow the proceeds into a Roth IRA without doing your homework first. You need to have enough earned income (generally, that means income from a job) to cover the amount of your IRA contribution. For example, if you want to contribute $6,000 to a Roth, you'd need to have at least $6,000 in earned income to do so. Unfortunately, income drawn from your retirement accounts doesn't count. Note that you can't make additional traditional IRA contributions after age 70 1/2.

Funds in a traditional IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax free, and can be withdrawn tax free if assets are held for five years. A 10% federal tax penalty may apply for withdrawals prior to age 59 1/2. Please consult with a financial or tax professional for advice specific to your situation.

How Can Grandparents Help with College Costs?

If your grandchildren are fortunate enough to have you chip in with their college costs, there are a few things you need to be aware of before you start writing checks.

The most straightforward way for a nonparent to help a student pay for college is with a cash gift. Gift tax rules in 2013 allow any individual to give another individual up to $14,000 per year ($28,000 from a couple) without the gift counting against the lifetime estate tax exemption. A problem with this approach is that your contribution will be taken into consideration when the student applies for need-based financial aid. Cash given directly to a student the year before he or she applies may be considered student income, reducing need-based aid by as much as 50% of the amount given. Furthermore, money held in the student's name is treated as a student asset, reducing aid by another 20%. Cash given to the parents also counts against financial aid, albeit at a much lower rate of up to 5.64%. To potentially avoid any financial aid impact with a cash gift, keep in mind that the Free Application for Federal Student Aid takes into account income from the prior year in determining need-based aid. Hence, consider giving the money when you know the student will not be applying for aid next year.

Another approach is to offer to help pay back the student's loans. By waiting until the student is done with school, you avoid financial aid concerns and help ease his or her debt burden as the student enters the workforce. This strategy may be particularly useful for students with subsidized loans, which don't begin to accrue interest until after graduation.

Grandparents may also open a 529 college-savings account in the name of a student. One of the advantages of this approach for the account owner (the grandparent) is that many states offer income tax deductions on 529 contributions, though you must typically make the contribution to your home state's plan in order to earn the deduction. Another benefit is that the IRS allows a five-year acceleration of the gift tax exclusion for such contributions, allowing an individual to contribute as much as $70,000 in a single year to a 529 in a student's name. A disadvantage to this approach is that distributions from a 529 owned by someone other than the student or his or her parents are counted as student income and may reduce the amount of need-based financial aid available by $0.50 for every dollar distribution. Waiting to use 529 distributions from a grandparent-owned account until the student's final year is one way to avoid this problem.

One final option that some grandparents might consider is paying tuition directly to the university on the student's behalf. This has special appeal for those who want to give large amounts but who are worried about gift tax consequences. The good news is that payments made directly to the university to cover tuition are exempt from the gift tax, although additional costs such as room and board are not. Unfortunately, direct tuition payments may be counted as either income against the student's financial aid allocation (reducing it by 50%), or as a financial resource available to the student (reducing financial aid dollar-for-dollar). Hence, this only makes sense for students who are not concerned about need-based aid or if the payment is made during the final year of school.

Tax law is ever-changing and can be quite complex. It is highly recommended that you consult with a financial or tax professional with any tax-related questions or concerns. An investor should consider the investment objectives, risks, and charges and expenses associated with municipal fund securities before investing. More information about municipal fund securities is available in the issuer's official statement, and the official statement should be read carefully before investing. 529 plans are tax-deferred college savings vehicles. Any unqualified distribution of earnings will be subject to ordinary income tax and subject to a 10% federal penalty tax.

How Safe Is Your Life Insurance Policy?

So you've finally sat down with your financial advisor and answered important questions, such as do you need life insurance, how big of a policy do you need, and what type makes the most sense for you. One thing you don't want to happen after purchasing your life insurance policy is to find out the company that sold you the policy has run into financial trouble. If your insurer went out of business, not only would you be uninsured, but you would also have to reapply for a new policy at a potentially more expensive rate due to your age and health.

Fortunately, there is a system in place to ensure that policies remain in force even after the issuing companies become insolvent. All 50 states, plus the District of Columbia and Puerto Rico, have life and health insurance guaranty associations that step in to make sure that policyholders aren't left holding the bag if their insurance company becomes insolvent. In nearly all states, the limits of coverage are $300,000 for life insurance death benefits and $100,000 for the net cash value of the policy. Some states even have limits as high as $500,000 for both. Coverage is provided by the guaranty association in the state in which the policyholder resides, even if he or she purchased the policy elsewhere.

For customers who hold policies worth more than their state guaranty limits, one option is to buy multiple policies within those limits from different companies to reach the desired total amount. So, instead of buying a $1 million policy from a single company, you could buy $250,000 policies from four different companies. The downside is that not only is this somewhat inconvenient, but it also might result in paying more than you would for a single policy because of the additional fees involved, not to mention different premium rates. Consult your financial advisor to explore all your options.

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