CHARTING THE COURSE

Special Series of Briefs About Beacon's Client Services

Life's Two Certainties: DEATH and TAXES

Planning for One, Minimizing the Other

"Taxes ***are the price we pay for civilization."*** Oliver Wendell Holmes, Jr.

Taxes may be one of life's two certainties, but certainty in tax laws is an elusive concept. The US tax code is complex and has lots of categories for work and investment income and applicable tax rates—ordinary income, earned v. non-earned income, taxable interest, tax-free interest, private activity interest and AMT (Alternative Minimum Tax), qualified dividends, non-qualified dividends, capital gains short or long, passive activities...the list goes on an on. No wonder some investors just ignore taxes, while others avoid taxes to such an extreme that they often do harm to their portfolio (e.g. holding concentrated stock positions too long).

Beacon manages portfolios for individual clients, so we pay lots of attention to taxes and are mindful of ways to reduce them for our clients. Strategies seeking to manage taxes run the gamut from one extreme to the other. For example, depending on changes in tax rates as applied to different types of investment income, some approaches suggest putting all stocks in a taxable account if qualified dividends and capital gains rates are low(er). The same logic suggests putting all bonds in tax-deferred accounts to avoid current tax exposure. We think the best approach is being tax-aware, seeking the best total returns we can get for our clients while minimizing taxes—in other words, we are mindful of taxes but we don't let the "tax tail wag the investment dog." We think having balance (stocks and bonds) in taxable and tax-deferred accounts is best, and we carefully select asset types to minimize the tax bite. We don't think tax law changes should dictate major asset allocation changes. Stocks are volatile regardless of tax rules, and bonds are ever the stabilizing "anchor-to-windward" stabilizing force, providing income and often positive returns in tough stock markets.

TAXABLE ACCOUNTS

Ideally **Beacon** strives to help our clients accumulate wealth in both taxable and tax-deferred* accounts (and in some cases tax-free accounts like ROTH IRAs). This gives our clients the greatest chance to have a successful long-range financial goal plan to fund all life's necessities including retirement and legacy planning. We'll discuss TAX-DEFFERRED ACCOUNTS on page 2.

Our approach to tax-aware investing in TAXABLE ACCOUNTS is based on several key tenants:

⇒ **KNOW THY CLIENT.** **Beacon** obtains extensive knowledge of our client's income tax profile. We proactively plan their income tax outcomes with the input and assistance of their tax-preparer. Using a "best in class" income tax planner software program, we have an active database of years of filed income tax returns. This affords us detailed understanding of tax exposure and opportunities.

⇒ **TRACK PORTFOLIO POSITIONS BY TAX LOT.** Again using a "best in class" portfolio management/accounting software, **Beacon** tracks a client's portfolio by tax lot. We account separately for shares bought on separate occasions and at each different price. When it comes time to sell, we know how much each particular share cost our client, how long it's been held, since that will determine whether our client will owe taxes on the sale, and if so, how much.

⇒ **AVOID SHORT-TERM GAINS WHEN POSSIBLE.** Normally the applicable tax rate on an asset held for a short-term (as defined in the tax rules) is higher than if held for a long-term. So, there needs to be a compelling reason to sell an asset for a short-term (capital) gain considering the higher tax rate our clients will pay.

⇒ **TAX-FREE MUNICIPAL BONDS.** Most often our clients that are in the higher income tax brackets will benefit from having some or all their bond allocation invested in municipal bonds. While municipal bonds interest is generally free of federal income taxes, we have to be mindful of capital gains, taxes at the state level, or private activity bond interest subject to the AMT.

⇒ **WATCH THAT TURNOVER.** When **Beacon** selects our mutual fund partners, one factor we consider is their investment style. We seek managers that investment in businesses, not just stocks or bonds. Normally our managers hold positions for three to five years or more, generally assuring that if there are capital gains most will be of the long-term character rather than short-term. Many of our mutual fund partners have lots of their personal and family wealth invested alongside our clients. This "eat what you cook" scenario generally helps keep turnover lower.

⇒ **HARVEST LOSSES ON STOCKS AND BONDS.** No one bats 1000.00! Sometimes the most diligent research still results in a stock or bond having a market value below it's cost. Most all our mutual fund managers seek to minimize capital-gains tax exposure (long and short term) by selling securities that are underwater (provided their investment thesis for the holding is changed). At the client portfolio level, **Beacon's** extensive knowledge of our client's tax situation, and our tax-lot accounting tools (see page 1) affords us the opportunity to also perform "tax loss harvesting" when needed. And we're ever vigilant to avoid or lessen exposure to the IRS's "wash-sale" rules.

TAX-DEFERRED ACCOUNTS (e.g. IRAs, Qualified Retirement Plans, etc.)

Deferring an income tax liability is normally a guiding principle when **Beacon** advises our clients about allocating discretionary (surplus) earned income or cash flow into types of accounts. In rare occasions it may make sense for our client to pay taxes sooner rather then deferring to later. Examples include converting a traditional IRA to a ROTH IRA, making a ROTH IRA contribution when eligible, and exercising and converting stock options (or realizing a capital gain) ahead of a known tax increase. Pre-tax income that is used to fund a tax-deferred account like a 401k, 403b, or even a traditional IRA push the tax liability into the future—in many cases the very distant future. Generally the rules allow tax-deferred funds to accumulate to age 70-1/2 (the so-called required beginning date for taxable distributions to start). Even then clients can take full advantage of tax-deferral by distributing to themselves annually minimum taxable sums as required by law—the so-called required minimum distribution ("RMD"). In client situations suitable to taking only the RMD, with proper planning often our clients' surviving spouses and heirs can enjoy tax-deferral for many more years after the client's death. **Beacon's** is committed to clients' life-long tax-aware investing and planning.

DEATH and TAXES!

"The only things certain in life are death and taxes."

Benjamin Franklin

"Death and taxes may be certain, but we don't have to die every year."

Unknown

BEACON Financial Advisors Ltd.