Investor Insights & Outlook

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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.

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Jason is Senior Partner and Fixed Income Securities Specialists with Kerntke Otto McGlone Wealth Management Group. He is a Certified Financial Planner (TM) professional and a Registered Investment Advisor Representative.

He holds a Bachelor of Science Degree in Economics from Northern Michigan University, and earned his Master of Science in Financial Services (MSFS) degree from the Richard D. Irwin Graduate School at The American College in Bryn Mawr, Pennsylvania. This commitment to higher education and professionalism puts Jason in a select group who has reached this level of academic achievement in financial services, and puts him in a position to address a broad range of issues when working with clients.

Jason worked as an independent financial advisor for Ameriprise Financial for 9 years. He was a member of their Advanced Advisor Group until 2007 when he became a founding partner at Kerntke Otto McGlone Wealth Management Group.

Get Your Estate Plan in Gear

Estate planning laws have undergone swift changes over the past several years and may change again in the years ahead. If you're creating or updating an estate plan, it's essential that you seek the advice of an attorney who's well versed in this area. Before you hire an estate-planning attorney to draft or update your estate plan, it's important to understand your role in the estate-planning process.

Find a qualified attorney: Because your estate plan will likely need to be updated as the years go by and your personal circumstances change, it makes sense to find an attorney who practices in the community where you live. This can help you meet with him/her on an ongoing basis.

Take stock of your assets: Before you meet with your attorney, spend some time enumerating your assets and their value: your investment accounts, life insurance, personal assets such as your home, and your share of any businesses that you own. Also gather current information about any debts outstanding. Your estate-planning attorney is likely to provide you with a worksheet to document your assets and liabilities, but it's helpful to collect this information in advance.

Identify key individuals: Another important aspect of estate planning is identifying the individuals you trust to ensure that your wishes are carried out once you're gone.

Executor: A person who gathers all of your assets and makes sure that they are distributed as spelled out in your will.

Durable (Financial) Power of Attorney: A person you entrust with making financial decisions on your behalf if you should become disabled and unable to manage your own financial affairs.

Power of Attorney for Health Care: A person you entrust with making health-care decisions on your behalf if you are disabled and unable to make them on your own.

Guardian: A person who would look after your children if you and your spouse were to die when your children are minors.

Know the key documents you need: When you meet with your estate-planning attorney, he or she will make recommendations about your estate plan. At a minimum, you should ask your attorney to draft the following documents.

Last Will and Testament: A legal document that tells everyone, including your heirs, how you would like your assets distributed after you're gone.

Living Will: A document that tells your loved ones and your health-care providers how you would like to be cared for if you should become terminally ill; usually includes details about your views toward life-support equipment.

Durable (Financial) Power of Attorney: A document that gives an individual the power to make financial decisions and execute financial transactions on your behalf if you are unable to do so.

Medical Power of Attorney: A document that gives an individual the power to make health-care decisions on your behalf if you are unable to do so.

Manage your documents: Once your estate-planning documents are drafted, destroy any older versions of them. Notify your executor of the whereabouts of your estate-planning documents, and provide copies of the relevant documents to your executor, powers of attorney, and the guardian for your children.

Plan to keep your plan current: Last but not least, plan to keep your estate plan current. One of the biggest estate-planning pitfalls is drafting an estate plan but not keeping it up to date. Changes may include change in marital status, assets, financial status, death or ill health of your beneficiaries, executor, power of attorneys, or guardian.

The Best Ways to Give a Financial Gift to Children

Here are some of the key strategies to consider when giving children and grandchildren a financial boost. There's no one-size-fits-all answer: The right choice for your situation will depend on how much you intend to give as well as on your grandchild's life stage and the goal of financial assistance.

Set up a UGMA/UTMA account: UGMA/UTMA accounts provide a way to save on behalf of a minor child without setting up trust funds or hiring attorneys. As a donor, you appoint yourself or other adults (such as the child's parents) to look after the account. One of the key advantages with UGMA/UTMA accounts is flexibility: You can put a huge range of investment options inside a UGMA/UTMA, including stocks and mutual funds. If you're saving fairly small sums, these accounts can be a decent way to go, but there are two major hitches. The first is that the assets become the child's property when he or she reaches the age of the majority (18 or 21, depending on state of residence). This leaves the donor with no real control over how the money is spent. The second is that for college-bound children, substantial UGMA/UTMA assets can tend to work against them in financial-aid calculations.

Contribute to a 529 Plan: These plans may build college savings while possibly obtaining a tax break. If you're saving for a college-bound child or grandchild, section 529 college-savings plans may help you avoid the two key pitfalls of UGMA/UTMA accounts. First, the assets are the property of the account owner, not the child. So if one grandchild doesn't end up going to college, you can use the 529 assets for another grandchild. Second, because 529 plan assets are considered the property of the account owner, they can have a relatively limited impact on financial-aid eligibility. In addition, you won't owe taxes on 529 plan investment earnings from year to year, and withdrawals from a 529 plan account will be tax-free provided you use them to pay for qualified higher-education expenses, such as tuition and room and board. Finally, you may be eligible for a state tax break on your contribution to a 529 Plan. The availability of such tax or other benefits may be conditioned on meeting certain requirements.

Fund a Roth IRA: If your grandchild is older and working, you can contribute an amount equal to his or her earned income, up to $5,000, to a Roth IRA. As with a UGMA/UTMA account, you can put a range of investments inside a Roth; there are no investment minimums or age limits on contributions. The money inside the Roth can grow tax-free until retirement, and the vehicle also offers some flexibility for withdrawals before that time. Specifically, contributions to a Roth IRA can be withdrawn at any time and for any reason, to pay for college or anything else. Those who need to tap the investment-earnings piece of an IRA will owe income tax on that portion of the withdrawal, but they'll circumvent the 10% penalty on early withdrawals if they use the money for qualified college or certain other expenses. Despite the big tax benefits, Roth IRAs for children carry one of the key drawbacks that also accompany UGMA/UTMA accounts: The child maintains control over the assets and can use the money for whatever he or she wants at the age of majority.

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. 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.

Bonds: Tips to Keep From Getting Pinched

Encountering stock market losses early in one's retirement years can deliver a blow to an equity-heavy portfolio. If you've determined that your equity weighting is extremely aggressive relative to your risk appetite, reducing risk by altering your portfolio's asset allocation may be essential. The need to reduce the risk of your portfolio doesn't mean you have to move money directly from stocks to bonds. As you cut back on your equity exposure, it may be wise to move money into cash and/or short-duration bonds (duration is a measure of interest-rate sensitivity), then slowly and systematically move it into the bond market over a period of several months or years. This way, you may be able to obtain a range of purchase prices for your new bond holdings.

It's important to think about what you're trying to achieve by transitioning your portfolio to bonds as retirement draws near. Lower risk and liquidity may be the answer. One potential way to obtain both is to take some of the money you would otherwise have earmarked for bonds and use it to pay down debt, even low-interest mortgage debt. If having a paid-down mortgage will reduce your expenses in retirement, you will be reducing the need to raise cash from your portfolio to meet in-retirement living expenses.

Diversification does not eliminate the risk of experiencing investment losses. Stocks are not guaranteed and have been more volatile than other asset classes. Bonds are subject to credit/default risk, which is risk associated with the issuer failing to meet its contractual obligations either through a default or credit downgrade. Bonds are sensitive to interest rate changes. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest rate changes.

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