

The Road Map to Wealth Accumulation for the High Income Investor



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Recent changes in the tax law have magnified the value of tax-wise financial planning and investing for the high-income investor. Taxes are now one of the single biggest factors in successful financial planning for high income investors. This paper details the challenges faced by high income investors and offers financial planning and investment strategies designed to allow them to keep more of what they earn.

This paper is not just about investing, financial planning, or taxes. It is about how to create a financial structure and put the correct systems in place for “High Income” * investors to build greater resources to:

- ❖ Create real financial independence
- ❖ Structure financial affairs to control taxation on investable assets
- ❖ Feel in greater control of income and financial resources
- ❖ Have more resources to give for the charitably inclined
- ❖ Create a legacy

** For purposes of this paper, High Income will be defined as annual income from all sources being greater than \$200,000 and Ultra High Income being greater than \$400,000 per year.*

Taxes destroy wealth creation during high income years!

Investors often fail to realize that taxes are their largest expense. Income (both earned and unearned) is the focus of taxation in America. One can have a higher net worth and a lower income tax rate. Warren Buffet, one of America’s wealthiest men, was said to have a lower tax rate than his secretary since his income was derived from selling stock rather than from earning a salary. Individuals with higher earned income may put the same dollars into an investment, but will receive a smaller portion of profit than individuals with a lower income due to the progressivity of our tax code.

Buffet himself declares that he pays a 17.4 percent rate on taxable income. His secretary (Bosanek) likely pays an average of 34 percent.

—Forbes 1/25/2012

Figure 1

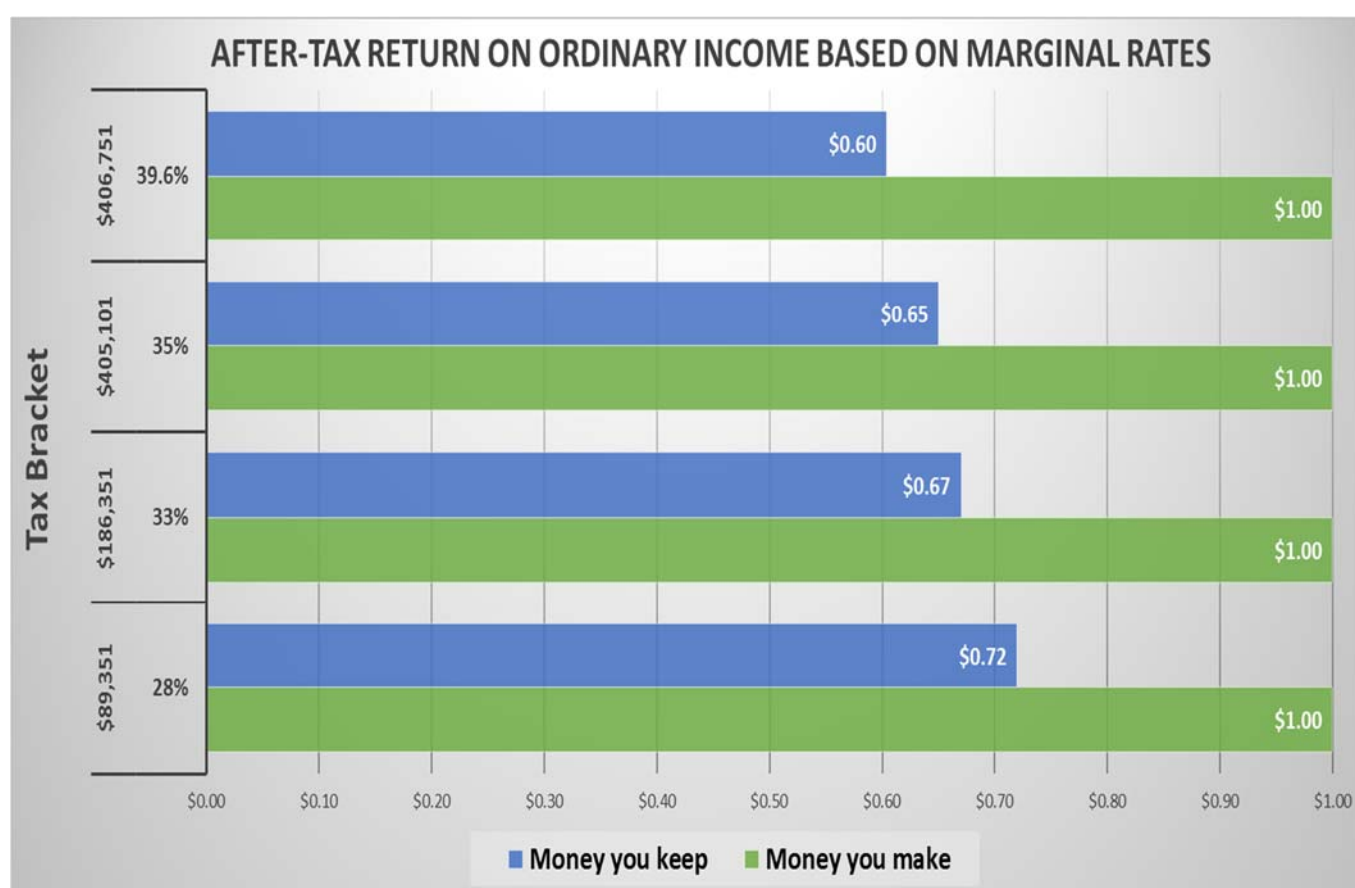


For high income earners, "ordinary income" from corporate bonds, REITs, short-term capital gains, options and certain other types of income is taxed at the highest marginal tax rate. Ordinary investment income not only "goes on top" but it may also get taxed with the Net Investment Income tax of 3.8% and state income tax. Very high income also causes the loss of some tax deductions and exemptions.

Investors take all the risk but have to share the return.

A dollar invested is put at risk; therefore, investors hope to receive a profit. Currently, in Tennessee, profits from that dollar in a taxable account may be taxed up to 49.4%. That is a lot of money to share with the government when the investor takes all the risk! If investments lose money, tax law only allows a deduction of capital losses greater than capital gains up to \$3,000 per year. The following charts illustrate the effect taxes have on the amount of investment income investors actually get to keep.

Figure 2



Based on 2014 "Single" rates. Illustrative purposes only

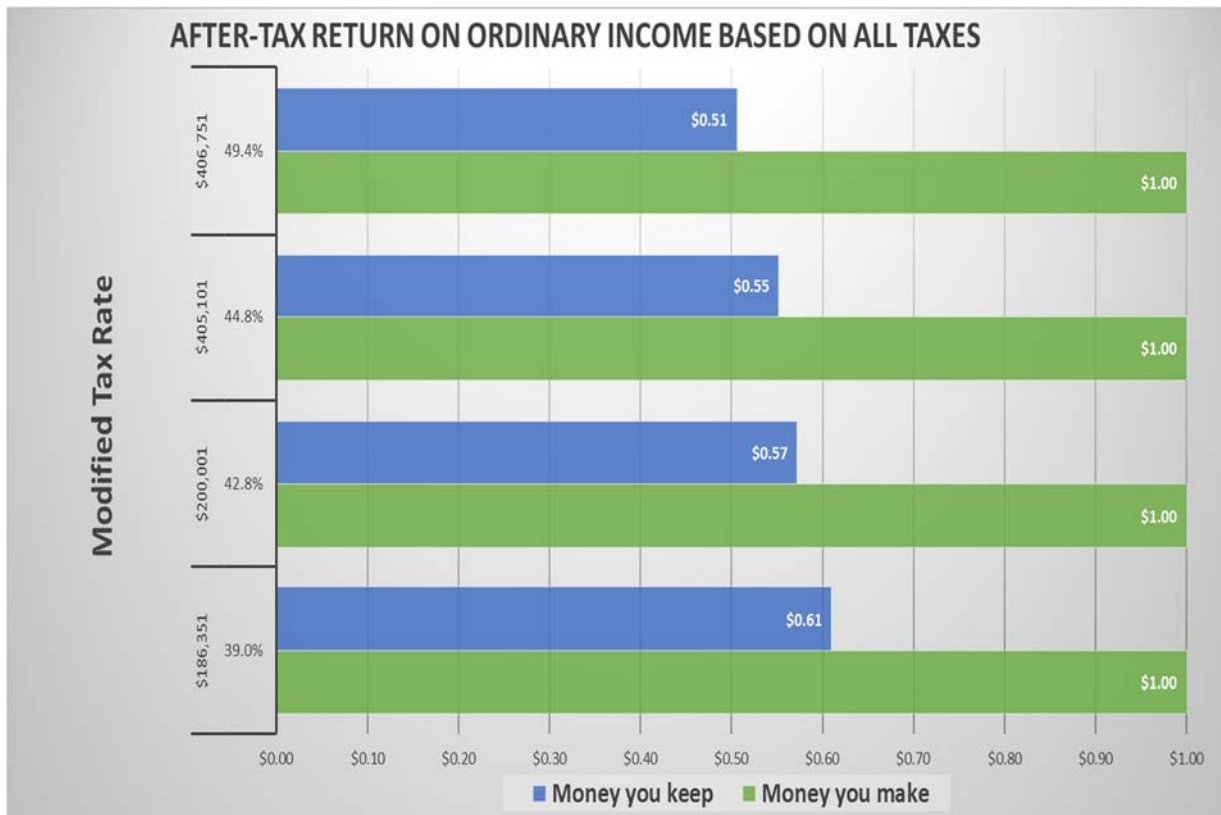
Unfortunately, the effect of taxation is more severe than it first appears. Investment income is further taxed by:

1. The Net Investment Income Tax (formerly known as the Medicare Surtax) of 3.8% when income goes over \$200,000 for Single filers and \$250,000 for Married Filing Jointly.
2. The 6% Tennessee tax on most **unearned** income (sometimes known as the "Hall Tax") after a small exemption on ordinary income (except short term capital gains).

3. The indirect increase in taxes caused by the loss of itemized deductions and personal exemptions (for the Ultra High Net Worth investor)

The graph below depicts a more accurate picture of the net after-tax amount kept from each dollar of ordinary investment income. Income from corporate bonds, real estate investment trusts (REITs), and certain other types of income is taxed at the highest rate. Additionally, the 3.8% Net Investment Income Tax and the 6% Tennessee Hall Tax combined with the 39.6% marginal tax rate can lead to a 49.4% tax rate on ordinary income.

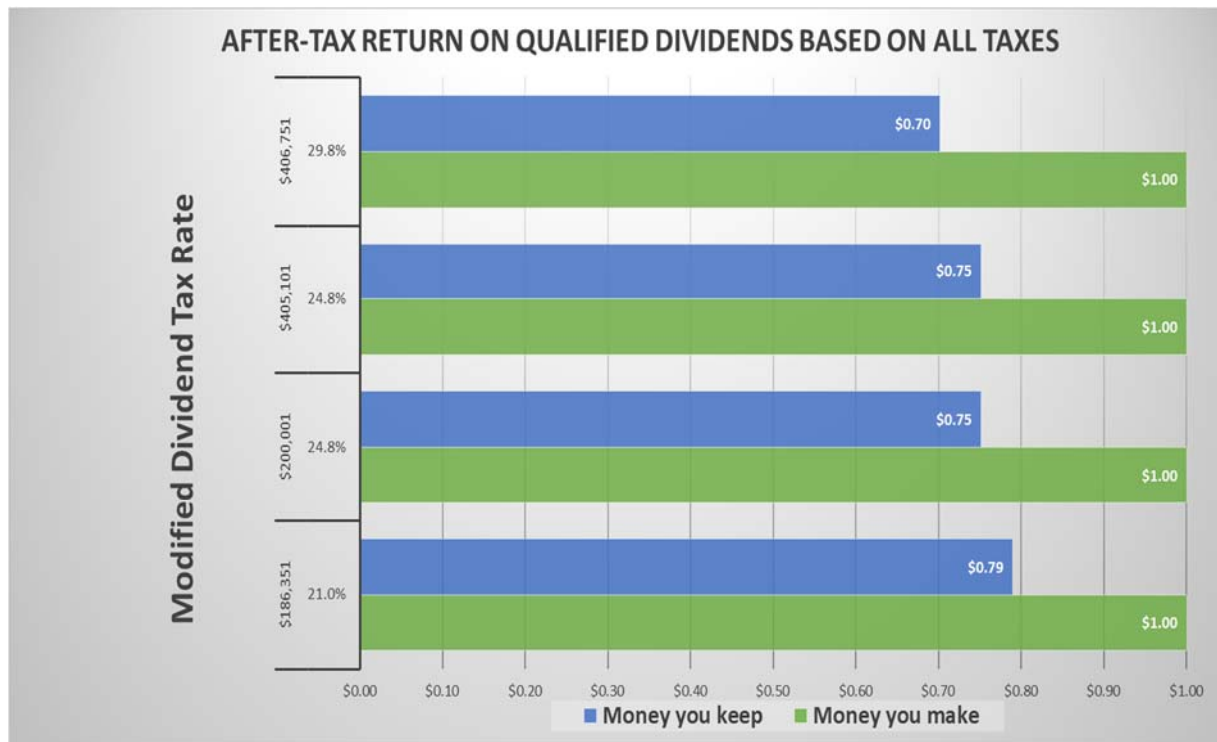
Figure 3



Based on 2014 "Single" rates. Illustrative purposes only

Qualified dividends from US companies and American Depositary Receipts (ADRs) from foreign companies are taxed at a more preferential rate. The 15% tax on qualified dividend income jumps to 20% for the Ultra High Income investor (above \$406,750 in 2014). The 6% Tennessee Hall Tax also applies to dividend income along with the Net Investment Income Tax of 3.8%. These three taxes together result in a 29.8% tax on qualified dividend income for the Ultra High Income investor.

Figure 4



Based on 2014 "Single" rates. *Illustrative purposes only*



Change your mind-set

Many investors resign themselves to paying their current tax rate on investment income. They fail to realize that they can restructure their financial affairs so that they can keep more of what they earn.

In The Millionaire Mind (the sequel to The Millionaire Next Door), millionaires stated that meeting with a tax advisor was one of their favorite activities. Sounds crazy right? Since they cannot control the stock and bond markets, millionaires do want to control the nature and the timing of taxes on their investments.

The “Mission” of High Income:

There is a saying in tax planning to not allow “the tax tail to wag the dog”.



Your mission should be getting the best return, and sometimes that does require you to pay tax. If two investments had the same risk profile, would you rather:

- a) Get a 10% return and pay 45% tax and keep the rest?
- b) Get a 2% return in which you pay 10% tax and keep the rest?

We obviously want to look for the best after-tax return - even if it means the government gets more. But what if investment “a” could be placed in a location that avoids current taxation of 45%? That can lead to the best of both worlds.

One should never structure investments just to save on taxes. Rather, investments should be structured to generate the best returns after taxes.

Strategic keys to success:

- 1) Strategic asset allocation- Understand the type of income produced by a given investment. Position “tax ugly” assets in tax-deferred or tax free accounts; hold tax-preferenced items in taxable accounts.
- 2) Create “tax diversification”- Set up as many types of accounts as possible (taxable, tax deferred IRA /401k, Roth IRA, 529 accounts, custodian, and possibly life insurance/annuities

products (in very specific situations). We cannot predict what the tax code will be in the future so diversifying creates many “buckets” from which to withdraw money in retirement.

- 3) Charitable giving/ Estate planning – A plan should be put in place for the charitably inclined and for those wishing to leave legacy.
- 4) Implement an investment policy statement – ensuring “exciting spur of the moment investments” do not get in the way of your wealth creation. Most investments that need to happen today are most likely speculative in nature.
- 5) Tax planning- Discuss strategies with your CPA.

What are the types of investments that a high-income investor should consider for taxable accounts?

- Tax efficient index funds
- MLPs - oil and gas master limited partnerships
- Non-publicly traded REITS (recommend less than 10% of liquid assets)
- Muni- Bonds

What types of investments should be avoided in taxable accounts?

- Actively managed mutual funds. Especially those with high turnover.
- “Tax ugly” assets (REITs, taxable bonds)
- Investments made for the sole purpose of avoiding tax
- Hedge Funds (high turnover and high fees)
- Commodities

Intelligent Financial Structure Using all Types of Accounts:

Qualified vs. Non-Qualified Accounts

Federal tax law designates certain types of investment accounts as **Qualified**. This means that these accounts have certain tax advantages over **Non-Qualified** accounts. Examples include company retirement plans such as 401(k)’s, 403(b)’s, Simple IRAs, SEP IRAs, and traditional pensions. This means qualified accounts are tax-deferred, meaning investors do not pay any tax on the investments until funds are withdrawn. Individual retirement plans such as contributory and rollover IRAs are taxed deferred as well. High Income investors should consider using tax- deferred accounts if there is a belief that their tax rates may stay the same or go down in retirement. These investments grow tax-deferred and are not subject to tax until funds are withdrawn.

Roth IRA's and 529 College Saving Plans are tax-advantaged. As long as certain rules are followed, the Roth and the 529 grow tax-free and may be withdrawn without ever paying taxes! Rules must be followed with all account types- the IRS does not forgive ignorance (Always check with your tax professional before deciding to withdraw funds). Tax assumptions, types of accounts, and goals should be reviewed periodically as tax laws and investors' goals change.

Taxes: Distributions from **qualified accounts** and IRAs are taxed as ordinary income, which can be as high as 39.6 percent. In taxable accounts, dividends and interest are taxed annually. Any profits from the sale of stocks, bonds and other assets held longer than one year are subject to capital gains tax rather than ordinary income. Under current law, capital gains rates are taxed at the long-term capital gains rate of 15% or 20% for High Income investors. Adding the Net Investment Income Tax of 3.8% can result in effective tax rates of 18.8% and 23.8%.

Creating different account types such as tax deferred, tax free, and taxable results in "tax diversification" that can be very useful to high income investors. This diversification allows for flexibility with retirement withdrawal strategies and protection from unforeseen future changes to the tax code.

Understanding Asset Location:

Understanding the tax treatment of income from different types of investments (asset classes) determines where these investments should be located in an investor's portfolio. For example, income from "tax ugly" assets, such as taxable bonds and publicly traded REITs will suffer maximum taxation if held in taxable (brokerage) accounts.

- **Taxable (Corporate, U.S. Government, Foreign, High Yield) Bonds** – Interest income is taxed as ordinary income. For this reason, these investments are best held in qualified accounts and IRA's.
- **Municipal Bonds** – Interest income is exempt from federal tax but may be subject to state taxation. Muni bonds should only be held in taxable accounts.
- **Publicly Traded Real Estate Investment Trusts (REITs)** – Income is taxed as ordinary income. REITs are best held in qualified accounts and IRA's.
- **Private REITs** – Since depreciation flows through to unit holders, income is mostly tax deferred. Private REITs should be held in taxable accounts.
- **U.S. Stocks, U.S. Equity Index Funds** – Most dividends from U.S. stocks are qualified and are taxed at a lower rate. These can be held in all accounts depending on individual situations.
- **International Stocks, International Equity Index Funds** – Depending on international tax treaties, dividends may be qualified or ordinary dividends. Foreign countries typically tax U.S. investors by withholding a portion of the dividend distributions. This foreign tax can be taken as a credit on U.S. tax returns if held in a taxable account. Qualified accounts and IRAs are not eligible for this tax credit.

- **Actively Managed Funds** – “Turnover” or the buying and selling of new holdings, adds an additional element of taxation to actively managed mutual funds. Turnover produces both long term and short term capital gains taxes in addition to taxes on dividend and interest income. For this reason, actively managed funds are best held in a qualified account or IRA if you must use them. For further insight into the tax consequences of high turnover in an account, see Appendix 4.
- **Gold** – Gold, physical gold funds, silver and other physical metals (along with vintage wines, stamps, artworks and antiques) are classified by the US Internal Revenue Service (IRS) as “collectibles”. When you sell an investment in collectibles that you held for more than a year, your gains are taxed at a higher rate than the rate that applies to stocks, bonds or mutual funds. Short term gains (held less than one year) are taxed as ordinary income, while the long-term capital gains rate on collectibles is 28%. Gold and collectibles are best held in tax-deferred accounts.
- **Commodities / Managed Futures:** A trader or investor who owned commodity ETF shares or managed futures during the year must use the K-1 of reported profits and losses along with his trading profits and losses when filing his income tax return. The gains from futures trading are taxed at a blended rate of 60% long-term and at 40% short-term. Unlike traditional securities, there are no "holding periods" for futures contracts. Open trade profits or losses are treated as realized capital gains or losses as of the last day of the year and the 60/40 rule is applied to the gross profit or loss achieved during the year. This type of investment is best held in an IRA or 401(k).

Note: It is possible to have reportable K-1 gains from owning commodity ETF shares greater than the profits actually earned on the shares. An investor with large commodity ETF holdings may be required to file state income tax returns in several states due to the partnership nature of these funds.

- **Commodity Exchange Traded Notes (ETN)** -An alternative to commodity ETFs. An ETN is not backed by other futures or the physical commodity. These funds are only backed by a promissory note from the ETN issuer. Most commodity ETN’s track the value of a basket of commodities and do not distribute income. If one sells the ETN, the gain may be short or long-term, just as in the case of stock or bond ETFs. Commodity ETN’s are best held in a taxable account.
- **Master Limited Partnerships (MLPs)** – MLPs combine the tax benefits of a limited partnership with the liquidity of publicly traded securities. Since both income and depreciation flow through to the MLP unit-holders, income distributions are classified as a combination of return of capital and qualified dividends. MLP’s distribute partnership K-1’s to unit-holders, which can complicate tax preparation. Individual MLP’s are best held in taxable accounts.

MLP Exchange Traded Funds (ETF) and MLP Mutual Funds - Income distributions are classified as a combination of return of capital and qualified dividends. Investors receive a simple 1099 and corporate taxes are paid by the fund, which lowers the net return to the

investor. These funds are best held in non-qualified (taxable) accounts. MLP ETFs must pay taxes over 30% as they are taxed as C corporations, so part of the benefits of MLPs are lost due to the extra tax.

- **MLP Exchange Traded Notes (ETN)** – Income distributions are taxed as ordinary income. Distributions are not reduced by corporate taxes paid at the fund level. MLP ETN's should be held in tax-deferred accounts.

Asset Class	Income Taxation	Recommended Location
Taxable Bond	Ordinary Income	Qualified, IRAs, Roth
Publicly Traded REITs	Ordinary Income	Qualified, IRAs, Roth
US Stocks, Equity Index Funds	Dividend Income	Taxable
International Stocks	Dividend Income	Taxable, or Qualified, IRAs (depends), Roth
Actively Managed Equity Funds	Dividends & Cap Gains	Qualified, IRAs, Roth
Gold, Silver, Collectibles	No income; 28% Cap Gain	Taxable
Commodities/Managed Futures	60% LTCG/40% STCG	Qualified, IRAs, Roth
Master Limited Partnerships	Tax Deferred	Taxable

It is not necessary to memorize the tax code, but one should work with a financial planning and investment management team (along with your tax professional or CPA) that emphasizes tax-efficient strategies.

Variable Annuities:

Variable Annuities (VAs) – Annuities may be purchased in both taxable and tax-deferred accounts depending on whether they are funded with pre-tax or after-tax dollars. In either case, they grow with tax deferral, but withdrawals are taxed differently. For a non-qualified

annuity, earnings must be withdrawn first and taxed as ordinary income. The 10% tax penalty applies to early withdrawals before age 59 ½. Non-qualified annuities have no contribution limits.

Although most variable annuities are sold as high-commission and high-fee products, there are *new* low-cost annuities available that can allow investors to shield investment income from current taxation.

In the past, we did not recommend variable annuities for the following reasons:

- High fees for guarantees and insurance
- High commissions
- Surrender periods
- Accumulated income must be withdrawn first and taxed as ordinary income
- 10% penalty for withdrawals of earnings before age 59 ½
- No step up in basis at death

While the majority of VAs are still expensive and less useful, a small percentage have changed. Several companies are now offering variable annuities with:

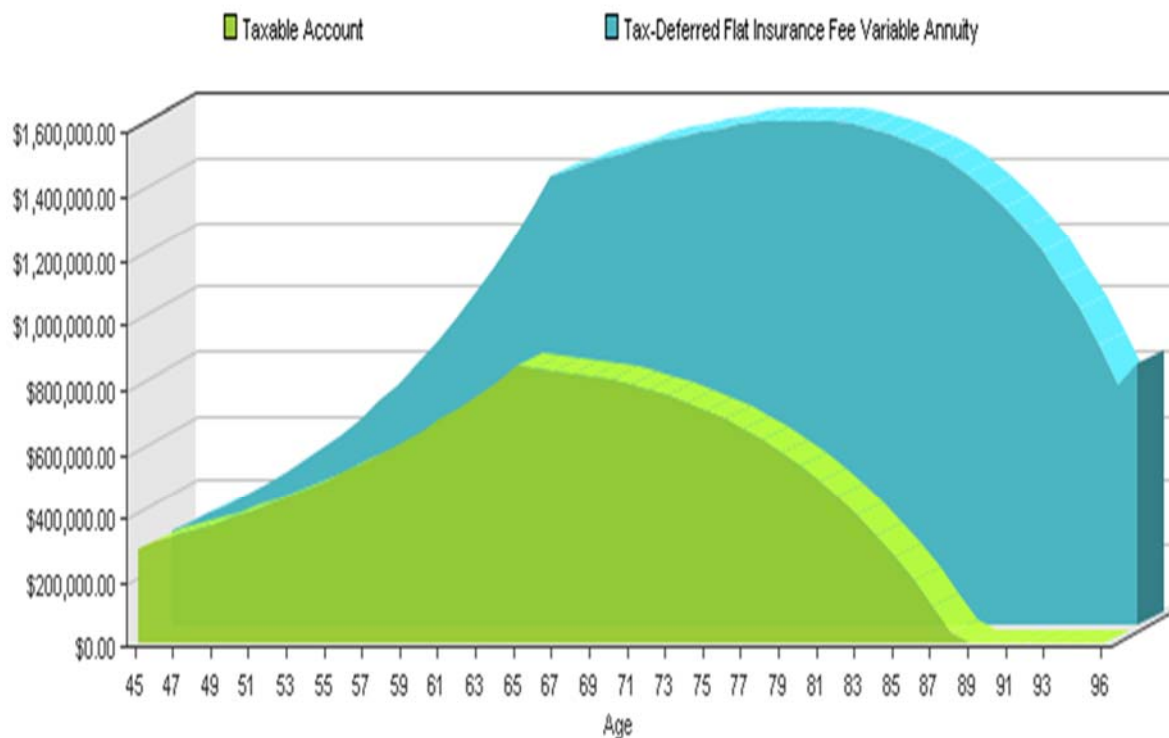
- Low cost
- No commission
- No surrender periods
- No slick sales person – available to fee-only advisors and planners
- New rules that allow a “stretch provision” for client’s beneficiary, much like a stretch IRA (must check the VA contract)
- No taxation by the state of Tennessee on withdrawals

These *new* low-cost VAs still have the following challenges:

- 10% penalty for withdrawal of earnings before age 59 ½
- Accumulated income must be withdrawn first and taxed as ordinary income.
- No step up in basis at death

The Power of Tax Deferral

401ks and IRAs are great for tax deferral. For High Income investors, there is now an opportunity to “purchase” tax deferral using a non-qualified annuity. There are some caveats to explore, but tax deferral can be powerful for certain investors. In addition, non-qualified annuities do not have Required Minimum Distributions (RMDs).



Figures 5 and 6. A 60% equity and 40% bond allocation showing the power of tax deferral before and after retirement. Low-cost variable annuity was purchased for \$300,000 at age 45 with annual withdrawals of \$75,000 beginning at age 65

Portfolio Type: Moderate		
Asset Class	Allocation	Return
Large Cap Equity	35%	9.41%
Small/Mid Cap	25%	11.47%
Long Term Bond	40%	4.71%

Assumptions			
Planned Distribution Age:	65	Planning Horizon Age:	95
Starting Balance:	\$300,000	Current Ordinary Income Tax Rate	35%
Inflation Rate:	2.6%	Distribution Ordinary Income Tax Rate	35%

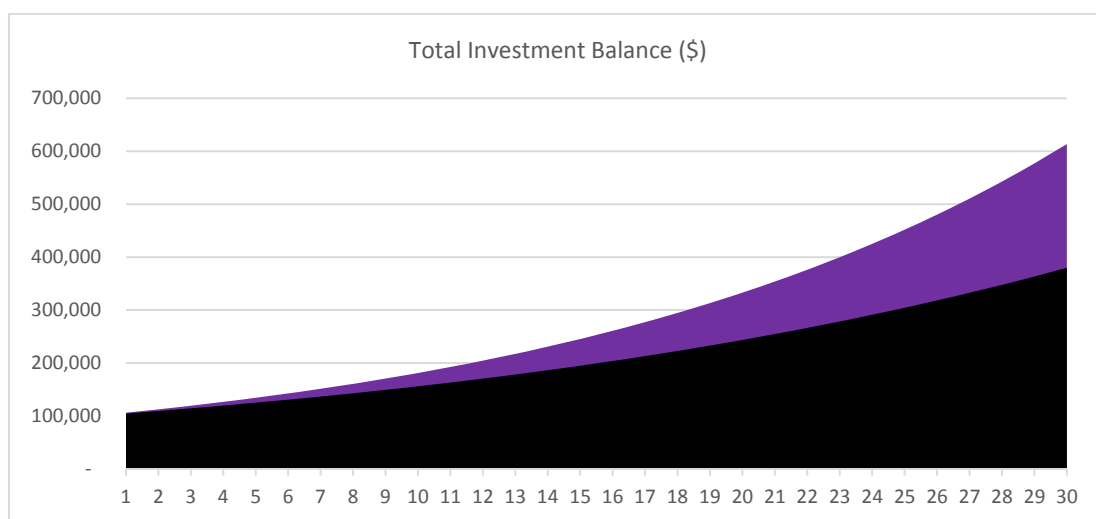
A note on Cash Value Life Insurance - Although some insurance companies promote a strategy to “invest through life insurance and borrow your money tax free”, we have not found a cost effective life insurance policy that has made sense for our client’s investment/wealth creation needs. We do not claim they cannot work, but we have not seen compelling evidence. Cash value life insurance policies sometimes may satisfy other insurance needs.

Low Turnover Strategy

One of the easiest ways to defer tax is to use investments that have no or low turnover. This strategy includes holding passively managed mutual funds and ETFs and avoiding actively managed mutual funds and high turnover trading strategies in taxable accounts. Based on illustrative data from Robert S. Keebler, CPA, MST, AEP (Distinguished), Keebler & Associates, LLP, a portfolio with 100% turnover requires an annual return of 11.7% BEFORE TAX to match a portfolio with 8.9% return and no (0%) turnover. The reason: 100% turnover results in 2.8% additional tax each year*. High income investors should think “low” when it comes to turnover in a taxable account.

* Please see appendix 4A for data

The graph below illustrates the negative impact that high turnover has on a portfolio. The cumulative effect over time can be very significant.



Data by: **Robert S. Keebler, CPA, MST, AEP (Distinguished), Keebler & Associates, LLP**

The purple portion indicates the after-tax growth of a low-turnover (10%) portfolio over a 30 year period. The after-tax growth of the high-turnover (100%) portfolio is depicted in black.

Please see Appendix 4B. TAX CONSEQUENCES OF LOW VS. HIGH PORTFOLIO TURNOVER for details.

Tax- Loss Harvesting- Using unrealized losses to offset income tax

Taxable accounts offer the advantage of using losses that can occur in some years to lower your tax liability. For example, a \$50,000 investment in a mutual fund in 2008, after the Great Recession, has dropped in value to \$30,000. Conventional wisdom is to continue to hold that fund, ignore the losses, and wait for the fund to eventually recover. However, in taxable accounts, this creates an opportunity to use tax-loss harvesting. Selling the fund and immediately replacing it with a similar (but not substantially identical*) fund has the net effect of booking a \$20,000 capital loss, while still maintaining the target asset allocation. Index funds lend themselves to this strategy because there are highly correlated indexes that are similar but not identical. * See IRS publication 550 for details on wash sale rules.

This capital loss is valuable in several ways. First, it will be used to offset any capital gains realized during that year. Taxes are due only if these capital gains are greater than losses. If losses exceed gains, up to \$3,000 of the remaining capital losses can be applied to reduce ordinary income. Any remaining capital losses can be carried forward and used in future years. While using tax-loss harvesting to offset capital gains doesn't actually eliminate the capital gains taxes, it defers those taxes into the future. The extra capital gains owed in the future should be at a lower taxable rate than current ordinary income rates. Offsetting ordinary income using future capital gains is especially beneficial to high income earners. If these shares are still held at death, heirs will receive a step-up in basis. In essence, the investor receives an immediate benefit from tax loss harvesting while avoiding the taxes on the back end entirely.

In summary, the three primary benefits of tax-loss harvesting are:

1. Offsetting realized gains and using remaining tax losses to deduct up to \$3,000 of ordinary income (which is taxed at a higher rate).
2. Carrying forward unused tax-losses to succeeding years and deducting \$3,000 per year of ordinary income until the losses are used up.
3. Deferral or elimination (at death or for charitable gift) of capital gains

Work, Earn, and Give! Setting Up a Charitable Plan:

If High Income investors are charitably inclined, there should be a charitable plan in place. While writing a check is easy, there are multiple strategies available. These strategies allow the High Income investor to give more *and* still maximize deductions. Successful strategies may include:

- Donating appreciated securities
- Giving to a Donor Advised Fund and taking a current deduction, then giving away those funds and its earnings in the future*
- Setting up a private foundation (only for high net worth clients)*
- Gifting Required Minimum Distributions (RMD) directly to charity subject to current law

*See Appendix 2 for Features and Benefits

The Benefits of Donating Appreciated Securities over Simply Writing a Check:

Gifting appreciated securities directly to a charity avoids all capital gains tax. This strategy allows the charity to receive the full market value of the stock while the donor gets the full allowable deduction while having never paid any tax. This creates the potential to give even more to charity.

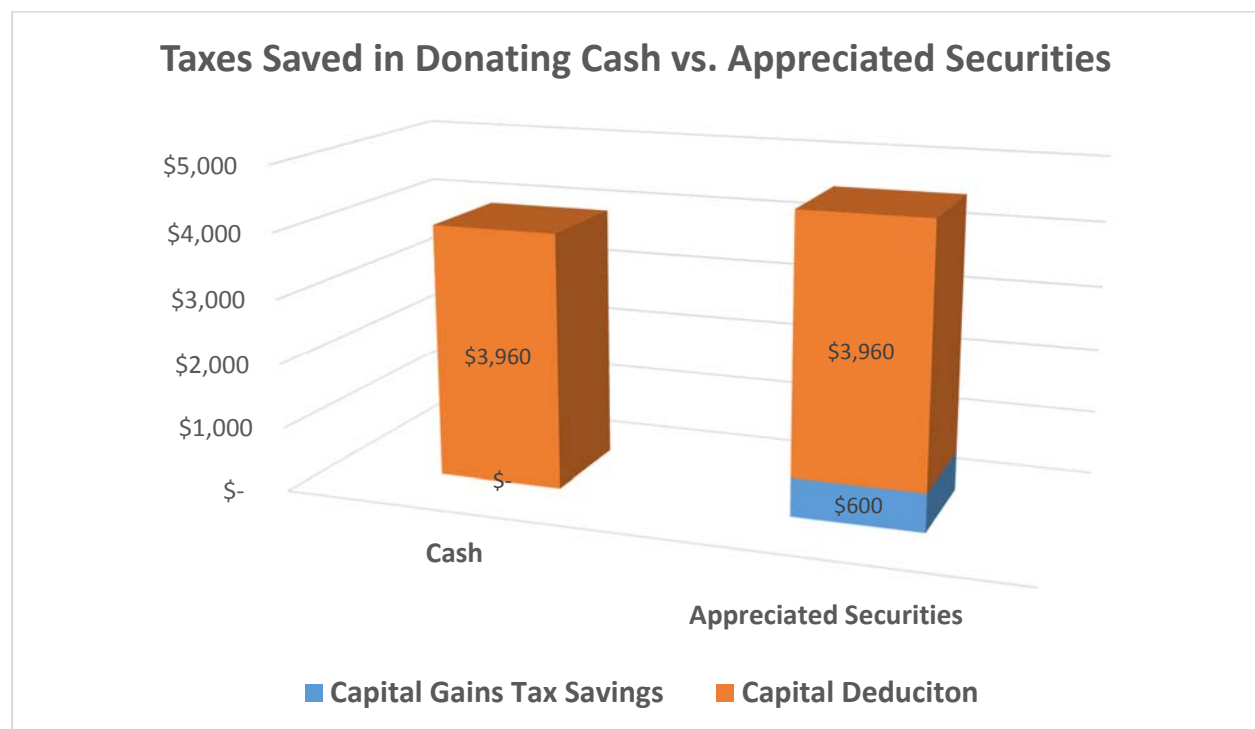


Figure 7. This example assumes a gift of \$10,000 in appreciated securities or cash from a taxpayer in the 39.6% tax bracket. It assumes that the appreciated securities were purchased for \$3,000 several years ago and are now worth \$10,000 and thus have \$7,000 of unrealized capital gain. It further assumes a 20% long-term capital gains tax rate. It does not take into account any potential effects of state and local tax, the alternative minimum tax, or the Net Investment Income Tax.

Can good planning bring quantifiable value?

How much does good financial planning, investment management, and tax planning potentially save clients every year...especially high income clients? Although the exact amount is hard to quantify, Vanguard recently published a study that tries to do just that. Their study found that advisors can potentially add value of about 3% per year. This High Income paper specifically discusses strategies relating to module I, module II, module III, and module V in the chart that follows. There are multiple other areas where an advisor may add additional value as well.

Figure 1. Vanguard quantifies the value-add of best practices in wealth management

Vanguard Advisor's Alpha strategy modules	Module number	Value-add relative to "average" client experience (in basis points of return)
Suitable asset allocation using broadly diversified funds/ETFs	I	> 0 bps
Cost-effective implementation (expense ratios)	II	45 bps
Rebalancing	III	35 bps
Behavioral coaching	IV	150 bps
Asset location	V	0 to 75 bps
Spending strategy (withdrawal order)	VI	0 to 70 bps
Total-return versus income investing	VII	> 0 bps
Potential value added		"About 3%"

Source: Vanguard, Putting a value on your value: Quantifying Vanguard Advisor's Alpha, March, 2014

Conclusion

Great financial planning should always include a focus on tax planning. In light of recent changes to tax law, including additional taxes and higher marginal rates, effective tax planning is now even more critical for high-income investors. Investment strategies must be reviewed proactively with a focus on the importance of low-turnover, investment taxation and asset location.

Successful tax planning first involves understanding the type of income generated by different investments and how that income is taxed. Next, creating multiple account types results in valuable tax diversification. Additionally, these account types allow for the placement of “tax ugly” assets in tax-deferred accounts and tax-preferenced investments in taxable accounts. Combining strategic asset location with low-turnover, passively managed funds in taxable accounts, leads to significantly higher after-tax returns. Finally, since many High Income families are charitably inclined, planned giving may result in larger donations to charities in a more tax efficient manner.

We recognize the difference between having high income and having high net worth. Our goal is to help high income clients turn their current *high income* into *high net worth*. We do this with the understanding that taxes are probably their biggest expense and largest obstacle to achieving financial independence. By utilizing these ideas consistently, high income individuals and families can accelerate their financial independence. These strategies work best when financial planning teams work with CPAs, attorneys, and other professionals.

- ❖ Special thanks to James Dickinson (who worked with our team), Robert S. Keebler, CPA, MST, AEP (Distinguished), Keebler & Associates, LLP for their contributions to this paper and Vanguard.

The authors have taken great care to thoroughly research the information provided in this paper to ensure that it is accurate and current. Nonetheless, this paper is not intended to provide tax, legal, accounting, financial, or professional advice, and readers are advised to seek out qualified professionals that provide advice on these issues for specific client circumstances. In addition, the authors cannot guarantee that the information in this paper has not been outdated or otherwise rendered incorrect by subsequent new research, legislation, or other changes in law or binding guidance. The author's efforts shall not have any liability or responsibility to any individual or entity with respect to losses or damages caused or alleged to be caused, directly or indirectly, by the information contained in this page. In addition, any advice, articles, or commentary included in the paper does not constitute a tax opinion and are not intended or written to be used, nor can they be used, by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer.

Appendix 1. STATE TAXES

Do you have a state income tax? It is just as real...and painful!



Tennessee State Income (Hall) Tax

- Exemption \$1250 single and \$2500 for married filing jointly
- 6% for most investment income above exemption
- Dividends, interest (except from banks)
- Active managed capital gains distributions (special)
- Long term capital gains are exempt
- Withdrawals from annuities are not taxable to the state.

If you live in one of the other 49 states, do you know your rules and rates...more importantly does your financial planning and investing team? Here are some of the highest tax rates in the country:

Simplistic addition using multiple tax rates including state tax *for illustrative purposes only*

State	State tax	Federal Rate	Net Investment Income tax	Effective State Rate	Total Effective Tax Rate
California	13.30%	39.60%	3.80%	8.03%	51.40%
Oregon	9.90%	39.60%	3.80%	5.98%	49.40%
New Jersey	8.97%	39.60%	3.80%	5.42%	48.80%
New York	8.82%	39.60%	3.80%	5.33%	48.70%
Connecticut	6.70%	39.60%	3.80%	4.05%	47.40%
Tennessee	6.00%	39.60%	3.80%	3.31%	46.71%
Ohio	5.42%	39.60%	3.80%	3.27%	46.70%
Massachusetts	5.25%	39.60%	3.80%	3.17%	46.60%
Pennsylvania	3.07%	39.60%	3.80%	1.85%	45.30%

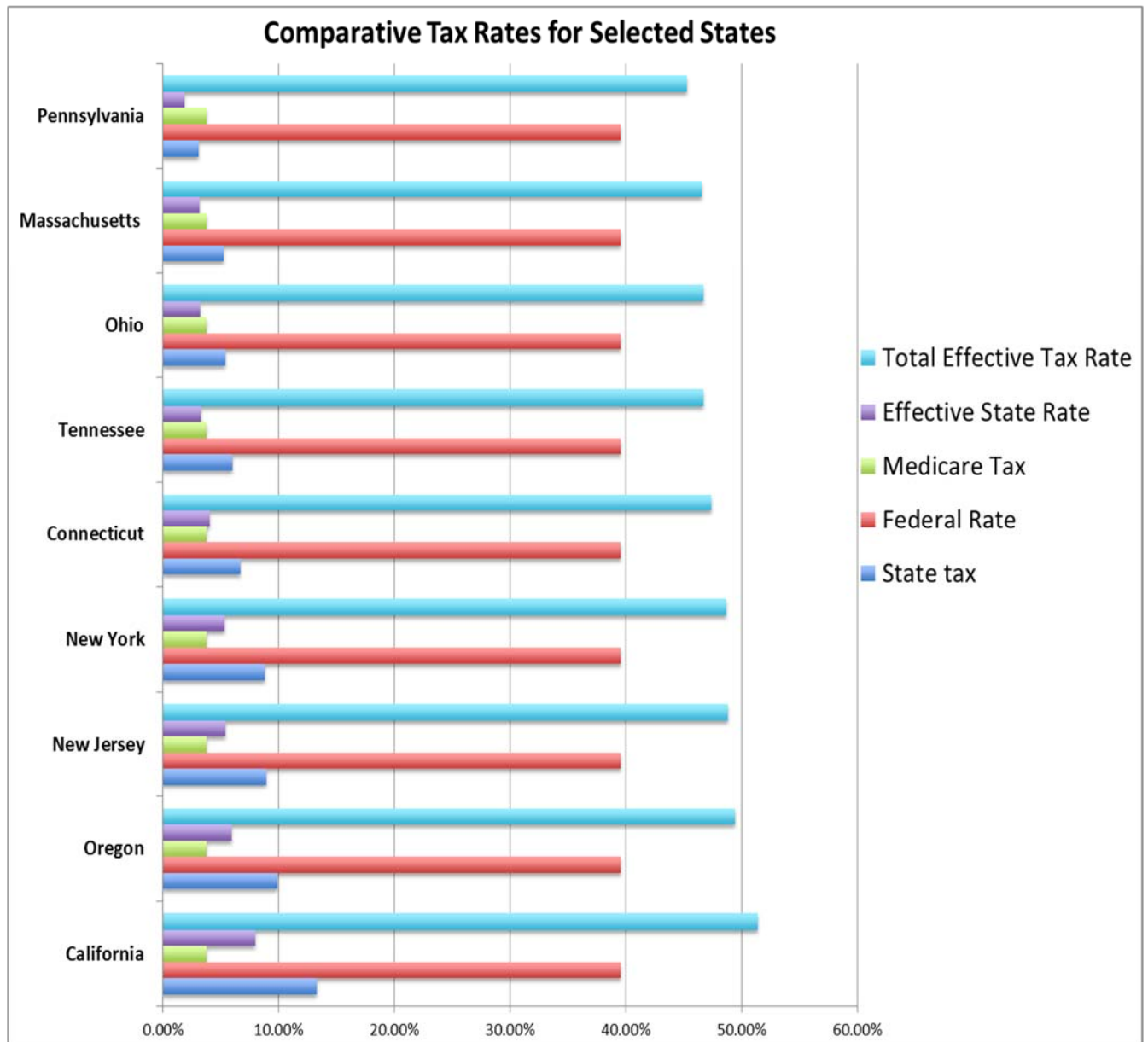


Figure 8. Total taxation in many states. Tennessee Income tax is only on unearned income and therefore may not always be deductible against federal tax for itemized deductions (known as Schedule A). The graph shows it to be fully deductible.

Appendix 2. CHARITABLE GIVING

	Direct Gift to Public	Private Foundation	Donor-advised fund (DAF)
Advantages	Simplicity: get money immediately	Can maintain family involvement and control over administration, investments, management, and distributions; individuals may receive compensation and be reimbursed for services to the foundation	Easy to establish and maintain with an initial contribution; treated as a public charity for tax deduction purposes; generally does not need to distribute account assets to charities each year
Disadvantages	Direct gifts must be made and annually accounted for	Required to distribute 5% of its assets each year to charitable organization; administration may be complex and must adhere to strict IRS rules, including "self-dealing" provisions; may incur excise tax on investment income; deductibility limitations are more restrictive than contributing directly to public charity; a sizeable amount should be donated to the foundation to cover startup and maintenance costs.	Limited control over fund management and administration; may require minimum contributions to open and have minimum dollar levels for grants; may not be able to grant scholarships to or otherwise help individuals.
Suitability	For High Income, immediate gift to a specific charity.	For High Income investors showing interest in exercising control over their charitable activities.	For High Income Investors who would like to avoid the cost burdens of a private foundation.
Initial Set-Up Cost	N/A	Typically at least several thousand dollars	None
Initial minimum funding amount	N/A	None although usually individuals do not open a private foundation with less than several million dollars because of their ongoing legal and administrative costs.	Varies, but typically cash or securities totaling at least \$25,000.
Excise Tax	N/A	Generally about 1% or 2% of annual net investment income.	None
Annual Distributions	N/A	Generally requires 5% of net investment assets.	None, but periodic distributions are often required.
Operating costs and fees	N/A	Varies	Varies
Tax Deduction	N/A	For new donations: up to 30% of AGI for cash gifts, up to 20% of AGI for publicly traded securities held more than one year.	For new donations: up to 50% of AGI for cash gifts, up to 30% of AGI for securities held more than one year.
Recognition or anonymity	N/A	Grants are a matter of public record.	Grants can be made anonymously
Administration	N/A	Foundation handles grant research and reporting requirements.	DAF program may handle grant research and reporting requirements.
Grants to Individuals	N/A	Permitted	Not Permitted
Control of Donated Assets	N/A	Donor may retain control of donated assets.	Donor may not retain control of donated assets.

Appendix 3. CASE STUDY:

High Net-Worth Investing with Mr. More and Mr. Less

We'd like to clarify some of the concepts discussed in this paper by using the example of two hypothetical high-income earning investors. We'll call them Mr. More and Mr. Less. Both Mr. More and Mr. Less are 50 years old and earn \$500,000 annually, putting them into the highest tax rates for income, capital gains, and dividends. Mr. More uses an independent registered investment advisor and invests in the most tax efficient strategies possible, while Mr. Less likes to invest on his own, relying primarily on each investment's annual return with little regard for their tax consequences. Let's take a look at some of the short and long term consequences of their investment decisions.

Strategy # 1: Lowering overall income

While it may seem obvious, an easy and often highly effective method to reducing taxes is to lower one's income through fully funding employer-sponsored plans like 401(k)s, IRAs and Health Savings Accounts (HSAs). Mr. More, our tax savvy investor, decided to fully fund his company retirement plan (limit \$23,000) and also max out his Health Savings Account (\$7550), through his company's high deductible health plan. In addition, Mr. More also funded a traditional individual retirement account (IRA) with \$6500. Mr. Less, on the other hand, decided not to invest in his company 401(k), deciding he could do better investing in a brokerage account on his own. He also failed to take advantage of his HSA account or put any extra money in an IRA. Initially Mr. More doesn't feel too bad about his decisions because his 401(k) doesn't have a match and he knows his income is too high to get a deduction for a contribution to an IRA. But by participating in his company plan and HSA, Mr. More immediately lowers his taxable income by \$30,550, resulting in him paying \$12,098 less in taxes each year (considering his 39.6% tax bracket). Additionally, Mr. More can convert his non-deductible IRA contribution to Roth IRA, known as a "back door" Roth each year. In just 10 years, Mr. More will have saved over \$120,000 in taxes! He also stashed away \$65,000 into a Roth IRA that he will never have to pay tax on any withdrawals or earnings! While it's true Mr. Moore will one day have to pay taxes on the withdrawals from his 401k, he is able to get compounded tax-deferred growth until that day, and also expects that he will no longer be in the highest tax bracket in retirement.

Strategy # 2: Asset Location and tax efficient choices

Let's look at Mr. More and Mr. Less and the importance of understanding the tax consequences of asset location. Both Mr. More and Mr. Less know the value of diversification in investing. Mr. Less understands it in the traditional sense, that investors should own a mix of stocks, bonds and REITs. Mr. More takes it a step further and implements "tax diversification," optimizing the location and type of investments to maximize his "after tax" or net return. To illustrate, Both Mr. More and Mr. Less want to buy similar investments: US stocks, real estate through REITs, and bonds that pay income and lower the overall volatility of their portfolios. Mr. Less likes actively managed funds, so he ends up with a portfolio like this:

ABC active US mutual fund, ABC REIT fund, and ABC Bond fund: he buys this portfolio in his brokerage account.

Mr. More and his advisor know they must take taxes into account in addition to evaluating individual investments based on expected returns and fees. So Mr. More ends up with a similar portfolio but with some subtle but important differences, plus he can chose the most advantageous account for that portfolio:

S&P 500 Index Fund, Muni-bond index fund, and REIT index fund.

Mr. More makes sure he places the tax inefficient investment, the REIT index fund, in his Roth IRA and the more tax efficient funds like the 500 Index fund and Muni-bond fund in his taxable account. Though the difference is subtle, let's see the outcome on a true after-tax basis. Let's assume they both invested 30,000 total split evenly between the Large Cap fund, REIT fund, and bond fund and they all had similar pre-tax returns.

Investment	1 YR Total Pre-tax Return	1 Year After-tax Return	Amount paid in taxes
Mr. More's Index Fund	10%	9.5%	\$50.00
Mr. More's Muni Fund	10% (5% appreciation and 5% Distributions)	10%	\$0
Mr. More's REIT Fund	10% (5% appreciation and 5% Distributions)	10%	\$0
Mr. Less' Active Fund	10%	8.4%	\$160.00
Mr. Less' Bond Fund	10% (5% appreciation and 5% distributions)	7.83%	\$217.00
Mr. Less' REIT Fund	10% (5% appreciations and 5% distributions)	7.83%	\$217.00

Because Mr. More used an index fund with low turnover, he kept his after tax returns very close to his pre-tax returns, even in his taxable account. He also chose to use a muni bond fund in his taxable account, thus he was able to avoid paying any tax on his bond distributions. Finally, he bought the REIT fund in his ROTH IRA, so he is able to receive the REIT distributions tax free.

Mr. Less, on the other hand, used an active mutual fund that had the same pre-tax return as Mr. More. However, because his fund manager moves in and out of stock positions in an attempt to generate higher returns, it leads to a high turnover rate and results in major tax consequences for the fund. Thus his fund's after tax return was only 8.4% (Research has shown the average active mutual fund loses 1.6% per year in returns to taxes- See Common Sense Book of Investing by John Bogle). In addition, Mr. Less' bond fund and REIT fund distributions are taxed as ordinary income, or 43.4% in his tax bracket- resulting in a 1 year after-tax total return that is 2.17% less for each fund!

In summary, both men start with \$30,000, but Mr. More ends up with \$32,950 and only pays \$50 in tax. Mr. Less ends up with \$32, 406 and has paid \$594 in tax. While this may not seem like a major amount, the savings really add up over a 10 year time horizon. Assuming Mr. More and Mr. Less add an additional \$30,000 a year to the accounts in the same manner, the difference becomes striking. Mr.

More will end up with \$521,011 and Mr. Less will have \$469,956. That's a \$51,000 difference for having investments with the exact same pre-tax returns!

Charitable Giving

In our last example, Both Mr. More and Mr. Less are very charitably inclined and like to donate to local charities. They both have had good success in the market the past few years and decided to donate a large amount (\$50,000) to help a funding drive at their respective churches. Mr. More and Mr. Less both have a \$50,000 stock that has highly appreciated from the original cost basis of \$20,000. Mr. Less decides to be smart and "sell high" and donate the proceeds to the church. Mr. More knows that the IRS allows donating stock directly to the charity and that this can be beneficial in a number of ways. Let's look at the numbers.

	Mr. More- Donates Stock	Mr. Less- Donates Cash
Fair Market Value of Stock	\$50,000	\$50,000
Taxes Paid: Capital Gains And Medicare surtax	\$0	\$7,140
Resulting Donation to Charity	\$50,000	\$42,860
Value of Charitable Deduction	\$19,800	\$16,973
Total Savings on Taxes (Value of charitable deduction less capital gains paid)	\$19,800	\$9,833
End Result: Give \$7140	more to charity and double the	tax savings

Summary:

Let's look at the total impact these simple decisions have made on the overall financial picture for Mr. More and Mr. Less after a 10 year time horizon. By contributing to his 401(k) and his HSA at work, he is able to save over \$120,000 in taxes. In addition, by paying close attention the tax efficiency and the location of his investments, he is able to accumulate over \$40,000 more than Mr. Less in his taxable account and Roth IRA. Finally, with their one time charity donation, he was able to give over \$7000 more to his church and save almost \$10,000 more in taxes by donating his appreciated stock!

Net Results after 10 years

	Mr. More	Mr. Less
Paid and/or Lost to tax		
-401k and HSA	\$0	\$120,980
-Asset location/selection	\$0	\$51,055
-Charitable Giving tax paid	\$0	\$7,140
-Charitable Deduction	-\$19,800	-\$16,973
Total	Saved \$19,800 in taxes	Lost over \$162,202 to taxes

Appendix 4A. TAX CONSEQUENCES OF LOW VS. HIGH PORTFOLIO TURNOVER

* Data provided by: **Robert S. Keebler, CPA, MST, AEP (Distinguished), Keebler & Associates, LLP**

Passive Investment Turnover						
	0%	10%	20%	30%	40%	50%
10%	8.93%					
20%	9.07%	8.94%				
30%	9.21%	9.08%	8.94%			
40%	9.36%	9.22%	9.08%	8.84%		
50%	9.51%	9.37%	9.23%	8.98%	8.94%	
60%	10.78%	10.61%	10.45%	10.29%	10.13%	9.97%
70%	11.10%	10.93%	10.77%	10.60%	10.43%	10.27%
80%	11.35%	11.18%	11.01%	10.84%	10.67%	10.50%
90%	11.56%	11.39%	11.22%	11.04%	10.87%	10.69%
100%	11.73%	11.56%	11.38%	11.21%	11.03%	10.85%

* Assumes assets held for a year or longer will always be turned over before assets held for a year or less.

* Assumes a 15% Rate on Qualified Capital Gains & 35% rate on all other capital gains

	10% Turnover								FMV of Sale	Basis of Sale	Gain Recognized
	Beginning Balance	Growth 7%	Taxes 15%	Ending Balance	Liquidate	Beginning Basis	New Basis	Ending Basis			
1	100,000	7,000	(105)	106,895	105,950	100,000	595	100,595	10,700	10,000	700
2	106,895	7,483	(207)	114,171	112,310	100,595	1,172	101,767	11,438	10,060	1,378
3	114,171	7,992	(306)	121,857	119,103	101,767	1,734	103,500	12,216	10,177	2,040
4	121,857	8,530	(403)	129,984	126,354	103,500	2,285	105,786	13,039	10,350	2,689
5	129,984	9,099	(499)	138,583	134,088	105,786	2,830	108,616	13,908	10,579	3,330
6	138,583	9,701	(595)	147,689	142,334	108,616	3,372	111,988	14,828	10,862	3,967
7	147,689	10,338	(691)	157,336	151,121	111,988	3,913	115,901	15,803	11,199	4,604
8	157,336	11,014	(787)	167,563	160,483	115,901	4,458	120,359	16,835	11,590	5,245
9	167,563	11,729	(884)	178,409	170,453	120,359	5,009	125,368	17,929	12,036	5,893
10	178,409	12,489	(983)	189,914	181,068	125,368	5,570	130,938	19,090	12,537	6,553
11	189,914	13,294	(1,084)	202,124	192,368	130,938	6,143	137,081	20,321	13,094	7,227
12	202,124	14,149	(1,188)	215,085	204,394	137,081	6,731	143,813	21,627	13,708	7,919
13	215,085	15,056	(1,295)	228,846	217,192	143,813	7,338	151,151	23,014	14,381	8,633
14	228,846	16,019	(1,406)	243,460	230,808	151,151	7,966	159,116	24,487	15,115	9,371
15	243,460	17,042	(1,521)	258,981	245,294	159,116	8,618	167,734	26,050	15,912	10,139
16	258,981	18,129	(1,641)	275,469	260,703	167,734	9,297	177,031	27,711	16,773	10,938
17	275,469	19,283	(1,766)	292,986	277,094	177,031	10,006	187,037	29,475	17,703	11,772
18	292,986	20,509	(1,897)	311,598	294,526	187,037	10,749	197,786	31,350	18,704	12,646
19	311,598	21,812	(2,034)	331,376	313,067	197,786	11,528	209,314	33,341	19,779	13,562
20	331,376	23,196	(2,179)	352,393	332,783	209,314	12,347	221,661	35,457	20,931	14,526
21	352,393	24,668	(2,331)	374,730	353,751	221,661	13,209	234,870	37,706	22,166	15,540
22	374,730	26,231	(2,491)	398,469	376,047	234,870	14,118	248,988	40,096	23,487	16,609
23	398,469	27,893	(2,661)	423,702	399,756	248,988	15,077	264,065	42,636	24,899	17,737
24	423,702	29,659	(2,839)	450,521	424,966	264,065	16,090	280,155	45,336	26,406	18,930
25	450,521	31,536	(3,029)	479,029	451,772	280,155	17,162	297,317	48,206	28,015	20,190
26	479,029	33,532	(3,229)	509,333	480,275	297,317	18,296	315,612	51,256	29,732	21,524
27	509,333	35,653	(3,441)	541,545	510,580	315,612	19,497	335,109	54,499	31,561	22,937
28	541,545	37,908	(3,665)	575,788	542,802	335,109	20,769	355,878	57,945	33,511	24,434
29	575,788	40,305	(3,903)	612,190	577,061	355,878	22,118	377,997	61,609	35,588	26,022
30	612,190	42,853	(4,156)	650,888	613,487	377,997	23,549	401,546	65,504	37,800	27,705

100% Turnover				
	Beginning Balance	Growth 7%	Taxes 35%	Ending Balance
1	100,000	7,000	(2,450)	104,550
2	104,550	7,319	(2,561)	109,307
3	109,307	7,651	(2,678)	114,280
4	114,280	8,000	(2,800)	119,480
5	119,480	8,364	(2,927)	124,917
6	124,917	8,744	(3,060)	130,600
7	130,600	9,142	(3,200)	136,543
8	136,543	9,558	(3,345)	142,755
9	142,755	9,993	(3,498)	149,251
10	149,251	10,448	(3,657)	156,042
11	156,042	10,923	(3,823)	163,141
12	163,141	11,420	(3,997)	170,564
13	170,564	11,940	(4,179)	178,325
14	178,325	12,483	(4,369)	186,439
15	186,439	13,051	(4,568)	194,922
16	194,922	13,645	(4,776)	203,791
17	203,791	14,265	(4,993)	213,063
18	213,063	14,914	(5,220)	222,758
19	222,758	15,593	(5,458)	232,893
20	232,893	16,303	(5,706)	243,490
21	243,490	17,044	(5,965)	254,569
22	254,569	17,820	(6,237)	266,151
23	266,151	18,631	(6,521)	278,261
24	278,261	19,478	(6,817)	290,922
25	290,922	20,365	(7,128)	304,159
26	304,159	21,291	(7,452)	317,998
27	317,998	22,260	(7,791)	332,467
28	332,467	23,273	(8,145)	347,595
29	347,595	24,332	(8,516)	363,410
30	363,410	25,439	(8,904)	379,945

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