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# Client Bulletin

Smart Tax, Business & Planning Ideas from your Trusted Business Advisor<sup>sm</sup>

## Calculating Retirement Needs

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A staple in retirement planning is the search for “your number.” That is, how much money do you need to accumulate in savings and investment accounts so you can afford to stop working? Life expectancy is increasing, so the amount you have when you retire might have to last for decades.

To find the number, you can start with a target for cash flow in retirement. Then determine how much you can expect from all anticipated sources of income: Social Security, a pension, rental income from investment property, and so on. The gap will probably be filled from your financial resources.

**Example 1:** Linda Morgan, age 52, hopes to retire at 65. Linda expects to need about \$75,000 a year for a comfortable retirement, with approximately \$25,000–\$30,000 coming from Social Security. She will not receive a pension from any employer and has no other obvious source

of retirement income. Therefore, Linda will need about \$45,000–\$50,000 a year from her savings and investment accounts.

### Doing the math

How can Linda find “her number,” the amount of financial assets she’ll need to generate \$45,000–\$50,000 a year in retirement? One tactic is to go online, where she’ll find many retirement calculators to crunch the numbers. Social Security, for instance, has a “Quick Calculator” at [ssa.gov/OACT/quickcalc/](http://ssa.gov/OACT/quickcalc/) to help you estimate future payouts from that source.

Many other websites offer more comprehensive retirement calculators. Frequently, they allow people to enter their personal information, then make various adjustments to future plans to see what methods might increase their chances for financial security after the paychecks stop.

**Example 2:** Linda uses a retirement calculator provided by the AICPA at [www.360financialliteracy.org/Calculators/Retirement-Planner](http://www.360financialliteracy.org/Calculators/Retirement-Planner). She enters the information from example 1 and other requested data into the calculator. In this hypothetical illustration, Linda is single, earning \$100,000 a year, and saving 15% of her earnings for retirement. Her future

## What's Inside

- 1 Calculating Retirement Needs
- 2 Taxable Versus Tax-Deferred Accounts
- 3 Small Companies Can Do Well While Doing Good
- 4 Tax Calendar

## Exporting Energy

*From January to February 2017, U.S. oil exports jumped by 35% to a record high of over 1 million barrels per day.*

continued on page 2

## Trusted Advice

### Tracking Tax Efficiency

- ▶ An investment's tax efficiency can be measured by its tax efficiency ratio. This shows how much of an investment return the investor keeps after taxes: after-tax return divided by pre-tax return.
- ▶ Say Jim Jones invests \$100,000 in ABC Corp. stock. The stock produces an annual return of \$10,000 and generates \$2,000 in tax.
- ▶ ABC has a tax efficiency ratio of 80% (\$8,000 after-tax divided by \$10,000 pre-tax).

expectations include salary increases (2% a year), investment returns (6%), inflation (3%), and living until age 95. Linda has \$300,000 in current retirement savings.

### Changing plans

The good news for Linda is that, with the inputs listed in example 2, her

retirement savings will top \$880,000 by the time she retires at age 65. The not-so-good news is that Linda's retirement savings will run out at age 83 if all of those expectations are met.

Fortunately, online calculators allow you to modify the data you enter and view the projected results. Some options for Linda include the following:

- **Increase her savings rate from 15% to 20%.** That would extend her retirement savings to age 86.
- **Decrease her desired retirement income from 75% to 70% of current income.** Again, her retirement savings would last until age 86.
- **Delay retirement from age 65 to 67.** This would allow her savings to last until age 90 because Linda would have two more years of earnings, boosting her nest egg over \$1 million and taking away two years of relying on her portfolio for support. (Annual Social Security payouts would also increase.)

What if Linda were to do all of the above? Work until age 67, save 20% of her income, and live on 70% of her current earnings in retirement? Now

the calculator shows Linda retiring with nearly \$1.15 million, tapping her portfolio until age 95, and having nearly \$475,000 of portfolio assets remaining.

### Fine tuning

With such calculators, there are countless modifications you can make to wind up with a satisfactory plan, at least on paper. In addition, you can go back to the calculator every year or two and update the data to see your current status, as well as make any indicated changes in your retirement plans. As you can see, retirement calculators provide a valuable service, enabling pre-retirees to make informed decisions about working, saving, and spending.

Nevertheless, these calculators may not be able to pinpoint your specific situation, including any plans to work part-time or tap home equity. Our office can go over retirement calculator results with you and suggest possible changes to enhance accuracy. We can also look at your plans in terms of pre-tax and after-tax cash flows, which may provide an even clearer picture of your retirement finances. ■

## Taxable Versus Tax-Deferred Accounts

Some people do all of their investing in an employer-sponsored retirement plan where earnings are untaxed until withdrawn, and perhaps in an IRA as well. Withdrawals are generally taxed at ordinary income rates, which now go up to 39.6%.

Conversely, others have taxable accounts as well; each year, income tax is due on investment interest, dividends, and net capital gains in these taxable accounts. Some dividends and gains qualify for favorable rates, currently no higher than 20%. (Taxpayers who are subject to the 3.8% surtax on net

investment income might actually owe 23.8%.)

Therefore, investors with a foot on both sides of the tax-now-or-tax-later line must make some decisions about their savings and investments. Which types of assets go into tax-deferred territory and which assets work better in taxable accounts? Making informed decisions can help you substantially in long-term results from your investments after tax.

Financial advisers and investment managers may have differing preferences in this area. Stocks inside retirement

accounts and bonds outside? Bonds inside and stocks outside? There are no universal rules to follow and there are many factors to consider when making decisions about asset location. The "correct" mix may vary from investor to investor. Nevertheless, some basic principles can help you in this decision.

### Liquidity

Emergency funds should be held in taxable accounts where you can reach them if the money is needed. That's also the case if you're saving for a major outlay, such as a home purchase or

higher education. With the money in a taxable account, you can access the funds without owing ordinary income tax or worrying about a 10% early withdrawal penalty before age 59½.

Historically, liquid dollars were often held in bank accounts and money market funds. Yields on these instruments are so low now that investors may be using short-term bond funds or something similar to get some return on their money. Even so, if you are holding assets for use in emergencies or for an anticipated expense, they probably should be in a taxable account.

### Availability

If you're saving for retirement in a 401(k) or similar plan, you'll be limited to the menu options presented to plan participants. Therefore, if your investment plan calls for an allocation to precious metals, you may have to use a taxable account for a fund that holds mining stocks, say, or a gold bullion ETF. The same could be true if you want to own an emerging markets bond fund or a small company growth fund, if no acceptable option in these categories is on your plan's menu.

Note that you can hold virtually anything in an IRA (except for life insurance and certain collectibles). Thus, your IRA could be used for hard-to-find assets.

### Tax magnitude

Assuming that liquidity and availability are not concerns, tax treatment will drive the decision about where to hold specific assets. One aspect to consider is the expected return of an investment. The lower that return, the lower the annual tax bill, and the smaller the advantage of deferring that tax. On the other hand, deferring large amounts of tax each year may be a good reason for using a tax-deferred account for a given asset.

**Example 1:** Martin Miller's asset allocation includes a high-quality corporate bond fund, now yielding around 2%. The fund seldom distributes capital gains to investors, so Martin expects to owe tax on that 2% payout this year and in succeeding years. In his 25% tax bracket, Martin would save 0.5% of his investment (25% bracket times the 2% yield) per year. That much tax deferral might not be enough to warrant holding the fund in a tax-deferred plan, so a taxable account could be the better choice.

Suppose that Martin's asset allocation also includes a high-yield corporate bond fund, now yielding 5%, which has a history of distributing taxable gains to shareholders. In his 25% tax bracket, Martin can expect to save 1.25% or more in tax each year. This fund could be a better choice for his tax-deferred retirement account.

### Tax efficiency

As mentioned, municipal bonds and muni funds often generate no income tax, so they are very tax efficient, whereas high-yield bond funds might generate steep annual tax bills, making them tax inefficient. As a general rule, you should try to hold assets with the least tax efficiency in your tax-deferred retirement plan.

**Example 2:** Phil Grant has an asset allocation that includes stock market index funds and funds that hold real estate investment trusts (REITs). Equity index funds tend to be tax efficient because they may have modest dividend payouts and seldom generate taxable gains, so Phil holds these funds in his taxable account. REIT funds may be tax inefficient, with relatively high dividends that might be fully taxable, as ordinary income. Phil puts his REIT funds into his tax-deferred account to avoid the annual tax bite.

Our office can go over the tax efficiency of investments you're considering to help you decide on the best location. As the saying goes, you shouldn't let the tax tail wag the investment dog. If you have a plan regarding which investments will help you attain your goals, you can get an added return when you know where to hold them. ■

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## Small Companies Can Do Well While Doing Good

The federal Small Business Administration reports that about 75% of small business owners donate some portion of their profits to charity each year. The average contribution is around 6% of earnings. Fulfilling philanthropic intentions has emotional rewards, and there can also be tangible benefits for your business. The more you align your charitable intentions with your

own passions, the greater the potential payoff.

One possible advantage is that your company's employees may truly get involved in your charitable activities. Consequently, they may become more productive overall and stay at your firm longer.

**Example:** Janice Peters is the primary owner of a company that

does printing and mailing. She is also heavily committed to animal rescue; she owns multiple dogs and cats that have been rescued from shelters, she temporarily fosters other animals for eventual adoption, and she contributes to animal welfare charities. Janice's donations come from her business profits and from her personal funds.

To get her employees involved, Janice provides financial incentives for pet rescue and volunteering in shelters. Selected departments have days for bringing their well-behaved pets to work, and Janice's company sponsors relevant fundraisers. The result of these efforts, Janice has discovered, has been the ability to hire likeminded people and exceptional retention of valued workers.

Such opportunities to mix business, charity, and advocacy are unlimited. A business owner who is a sports fan might back a youth team, for instance. If the cause you support relates to the environment, you might mention that your company is supporting a sustainability initiative, an idea that will resonate with many people. Yet another approach is to allow employees to have a voice in choosing charities the company will support.

### Spreading the word

Business benefits from charitable endeavors can be external as well as internal. Janice highlights her company's animal rescue activities on its website and through its social media presence,

all of which makes her company memorable to potential customers. She also sits on the board of some local animal rescue groups, where the other board members include business owners who share her interest. When they need printing and mailing, Janice's company often comes to mind.

### Tax treatment

Companies may very well reap tax benefits from their donations. C corporations can deduct charitable contributions against business income. Pass-through entities (S corporations, partnerships, LLCs) may pass through such deductions to business owners who itemize deductions on Schedule A of their personal tax returns. Note that if your company receives a direct benefit from its philanthropy—say you support a Little League team that advertises your company's name on its uniforms—the outlay may be deductible as a business expense rather than as a charitable contribution.



Services provided by you or your employees are not deductible. However, expenses involved while volunteering may count as a charitable contribution. Donations of property might be deductible at fair market value; special rules apply to donations from inventory.

Our office can help you determine whether a philanthropic outlay is a business expense or a charitable contribution. We can also explain how to obtain an acceptable valuation for any goods you might be donating. Maximizing the tax benefits will help your business get the most from its efforts to help others. ■

## TAX CALENDAR

### JULY 2017

#### July 17

**Employers.** For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in June if the monthly rule applies.

#### July 31

**Employers.** For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2017. Deposit any undeposited tax. If your tax liability is less than \$2,500, you can pay it in full with a timely filed return. If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

For federal unemployment tax, deposit the tax owed through June if more than \$500.

If you maintain an employee benefit plan with a calendar year-end, file Form 5500 or 5500-EZ for calendar year 2016.

### AUGUST 2017

#### August 10

**Employers.** For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2017. This due date applies only if you deposited the tax for the quarter in full and on time.

#### August 15

**Employers.** For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in July if the monthly rule applies.