CHAPTER EIGHT

Tax Strategies

Dear IRS,
I am writing to you to cancel my subscription.
Please remove my name from your mailing list.
— SNOOPY (CHARLES M. SCHULZ)

“Don’t let the tax tail wag the investment dog” is a quirky saying that has been a bastion for financial advisors for many years. It means to not let tax issues override smart investment decisions. However, with recent tax changes, smart tax planning is essential for smart investing.

Wise Tax Planning

Effective January 1, 2013, numerous tax changes went into effect that impact high-income earners. These included higher marginal tax rates, higher tax rates for capital gains and qualified dividends, new taxes for high-income earners, and a phase-out of personal exemptions and deductions. Most people anticipate more tax increases in the future.

Let’s review tax rates over the past 70 years. In 1944, the top federal tax rate was over 90 percent. It remained at approximately 90 percent until 1963. It was reduced to 70 percent in 1965, where

it remained until the early 1980s. Since that time it has declined significantly, with the top marginal tax rate capped at 35 percent between 2003 and 2012. Effective January 1, 2013, the top marginal federal tax rate rose to 39.6 percent.

Compared with the past 70 years, 39.6 percent seems like a reasonable tax rate. However, there are many other forms of taxes, and they can add up to a high number. For example, most states have state income taxes. The states that do not charge a state income tax tend to charge higher property taxes or gross receipts (sales) taxes to compensate. Some cities also have a separate income tax. Working people pay a Social Security tax and a Medicare tax. As consumers, we pay gross receipts taxes (or sales taxes) when we buy items, and we pay property taxes for the real estate we own. There are often additional taxes, such as when we buy a car, renew a driver's license, purchase alcohol or cigarettes, or pay for travel-related expenses, such as airlines, hotels, and rental cars.

In many cases, taxes cannot be avoided. I tell my clients we will work to maximize the after-tax money. For instance, if we sell a mutual fund that has increased in value in a taxable account, we know we must pay a capital gains tax on the gain. We accept that fact and work to grow the after-tax proceeds.

However, in many instances, wise tax planning can *save* a significant amount in taxes, leaving more money for your family and your financial security. Federal District Court Judge Learned Hand stated the following in 1934:

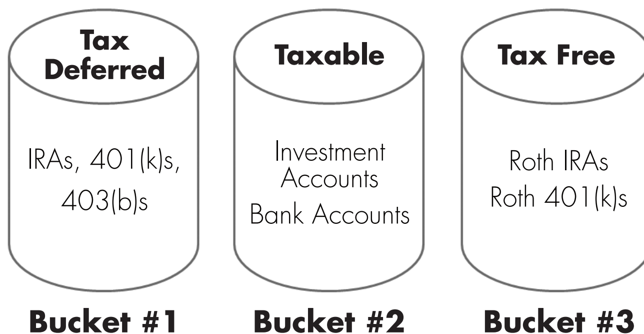
> *Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands.*

Clearly, minimizing your taxes is a wise strategy.

Three Tax "Buckets"

The key with tax planning is to be proactive. The purpose of having three different tax buckets is to minimize taxes now or in the future, and to provide flexibility when taking withdrawals. This strategy is also called *tax diversification*. Figure 8.1 shows a diagram of the three tax buckets.

FIGURE 8.1 THREE TAX BUCKETS



Bucket #1

This bucket is for tax-deferred assets, such as retirement accounts like traditional IRAs, 401(k)s, or 403(b)s. Typically, the money you invest in a traditional retirement account is deducted from your income in the year of the contribution. Taxes are not due until the money is withdrawn, and whatever amount is withdrawn is considered to be taxable income for that tax year. IRAs have been available since 1974, and these accounts have become the most common way to save for retirement.

Saving and investing *only* in bucket #1 was a wise strategy in the past for those who expected their tax rate to decline during retirement. Bucket #1 takes advantage of the tax deferral benefits of

traditional retirement plans, so the tax rate during retirement is critical to this strategy working well. For many years, folks were encouraged to invest in a tax-deferred account (such as a 401[k] or a traditional IRA) rather than in a taxable account.

It is common for investors nearing retirement to have a large traditional IRA, but very little money in a taxable account. This could be termed “IRA rich, but cash poor.” However, many people no longer expect their tax rate to decline significantly during retirement, which is why having multiple tax buckets has become important.

Bucket #2

This bucket is for taxable accounts. Many people do not realize that saving and investing in a taxable account is always wise. The gains on this money are not tax-deferred, but investors with taxable accounts have benefitted for many years from the 15 percent preferential tax rate on capital gains and qualified dividends. This was raised to 20 percent effective January 1, 2013, but only for individuals and couples with high incomes. Most investors will still pay the 15 percent tax rate for capital gains and qualified dividends. (Persons in the 15 percent or lower marginal tax bracket do not pay capital gains taxes). Even if you must pay 20 percent, it is still a preferential tax rate when compared with higher marginal income tax brackets.

Bank accounts are taxable accounts, but I always encourage people to have a taxable investment account as well. I recommend building an emergency fund (in a taxable investment account or bank account) that will cover up to six months of living expenses. Once this emergency fund is established, any extra money (such as savings at the beginning of each month, a tax refund, or a bonus) should be deposited into your taxable investment account.

Bucket #3

This bucket contains tax-free accounts, such as a Roth IRA, Roth 401(k), or Roth 403(b). This is the newest bucket because Roth IRAs only became available to investors in 1998, with Roth 401(k)s and Roth 403(b)s becoming available during the past few years. Money invested in these accounts is not deducted from income in the year of the contribution, so there are no tax benefits on the front end. However, the tremendous benefit of a Roth IRA is that the contributions and the gains will not be taxed going forward. For this reason, a Roth IRA trumps a traditional IRA in my view.

For several years after Roth IRAs were introduced, some investors were concerned that the tax-free provision of the Roth would be eliminated and gains on Roth IRAs would become taxable in the future. This concern seems to have been put to rest during the past 15 years. More information about the benefits of Roth IRAs is provided later in this chapter.

Benefits of Having Multiple Tax Buckets

The three tax buckets provide you with choices regarding where to withdraw money during retirement, while also providing significant tax benefits and savings:

- It is common for those nearing retirement to have large IRAs but very small taxable accounts and no Roth IRA. One reason having all your investments in an IRA is *not* recommended is because taking IRA withdrawals during retirement (to pay your annual living expenses) can place you in a higher tax bracket than if you took the withdrawals from a taxable account. It can also cause Social Security benefits to be taxed at a higher rate and Medicare premiums to increase.

  Let's assume you estimate you will need $60,000 per year for living expenses during retirement, and your Social Security benefits total $20,000 per year. If all of your money is in an IRA,

you may need to withdraw as much as $55,000 each year in order to have $40,000 remaining after taxes for your living expenses. (This is because withdrawals from an IRA are taxed as income). Conversely, let's assume you have a large taxable account or a large Roth IRA, and you are not yet age 70½. You could withdraw the $40,000 you need for cash flow from your taxable account or your Roth IRA. This would result in much lower taxes because the money withdrawn from a taxable account or a Roth IRA is not taxed as income. This could also result in your Social Security benefits being taxed at 15 percent rather than 50 or 85 percent. Even if you withdraw a portion of the $40,000 from your IRA and a portion from your taxable account or Roth IRA, you would still owe less in taxes because only the IRA withdrawal is categorized as taxable income.

- In addition to reducing taxes by withdrawing from tax buckets #2 and #3, three tax buckets can also allow you to delay starting Social Security benefits, thereby letting the benefit accrue until a later date. Let's assume you retire at age 62 and your full retirement age (for Social Security benefits) is age 66. Full retirement age varies according to your birth date, but currently ranges from 65 to 67. If you have a significant taxable account (bucket #2), you can withdraw from that bucket between years 62 and 66 for living expenses and delay drawing Social Security benefits until age 66 or later. Delaying Social Security benefits until age 66 will result in the monthly benefit increasing by approximately 33 percent (as compared to the amount you would receive at age 62). By following this strategy, you may be in a very low income tax bracket between ages 62 and 66, which provides an opportunity to convert a portion of the traditional IRA to the Roth IRA each year.
- Converting a significant amount of a traditional IRA to a Roth IRA can reduce required withdrawals from the traditional IRA

at age 70½. Roth IRAs do not have required distributions, so if the withdrawals are not needed for living expenses, then the money can remain invested in the Roth IRA, growing tax-free for many years.

More Tax Strategies

Having your money in three different tax buckets is a valuable tax strategy. Keeping your investments tax-efficient can save a significant amount of money. However, the strategies need to be customized to match each person's situation. Below is a list of some common tax strategies. I recommend you work with your tax advisor or financial advisor to determine which strategies will work best for you.

- Keep the assets within your investment accounts tax-efficient. With the tax changes beginning January 1, 2013, most investors will continue paying a preferential 15 percent federal tax rate on capital gains and qualified dividends. For this reason, holding stocks or equity mutual funds that provide qualified dividends in a taxable account is wise. Select equity investments for a taxable account that tend to be tax-efficient. Most index funds are tax-efficient. Some actively managed funds are also tax-efficient, but avoid equity mutual funds with a high turnover ratio. (Turnover relates to how often the fund manager buys and sells stocks within the mutual fund. An annual turnover ratio can range from zero to several hundred percent.)
- Try to avoid placing equity mutual funds that have a very high *unrealized* capital gain in a taxable account. This happens when a fund has had strong performance in recent years, but the fund managers have not sold their big winners and have not yet triggered the capital gains. This can happen with any fund, but is most prevalent in actively managed funds. Morningstar provides the unrealized capital gain exposure for mutual funds on their

website at www.morningstar.com under the "tax" tab. When possible, these equity mutual funds should be placed in an IRA or a Roth IRA. (Because IRAs are tax-deferred and Roth IRAs are tax-free, capital gains taxes are irrelevant.)

- If you are in a high tax bracket, you may want to consider using municipal bonds (muni bonds) for the fixed-income portion of your portfolio in a taxable investment account. This could be accomplished with individual muni bonds or muni bond mutual funds. The muni bond interest will not be subject to federal taxes. When deciding what type of bonds to use in your taxable investment accounts, you should always compare the *after-tax* bond yield. In some cases a taxable bond may have a higher after-tax yield than a muni bond.
- Some advisors recommend using a strategy called *asset location*, which requires putting investments in certain asset classes in taxable accounts and investments in other asset classes in IRAs. In recent years they have typically advised putting the equity investments in taxable accounts and the fixed-income investments in IRAs. The rationale is that the equity mutual funds will distribute dividends and capital gains, which are taxed at 15 percent for most investors, and the bonds (in the IRA) will distribute interest. The interest would be taxed as regular income if it were present in a taxable account, but it is not taxed in an IRA. (Capital gains, dividends, and interest are not taxed in an IRA on an annual basis. Taxes are triggered when a distribution is taken from the IRA, and then the entire distribution is categorized as taxable income.)

Financial planner Michael Kitces has studied asset location strategies, and he has shown that following the typical advice (noted above) may *not* maximize after-tax returns. Many variables come into play, including tax efficiency, return assumptions, and complications resulting from other asset classes. In March 2013

he recommended that it may *not* be wise to place most bonds in tax-deferred accounts.

There is another flaw in using an asset location strategy, and it involves the emotional reactions we all have as investors. If the stock market has a sudden decline as it did in late 2008 and early 2009, investors will be traumatized to see their taxable account (which would contain mostly equities if this strategy were followed) drop by roughly 50 percent. Telling them that their IRA did not nosedive (because it is in bonds) would not provide much consolation. Other tax planning strategies provide significant benefits without exposing investors to undue stress.

- Avoid excessive trading in your account. When selling an asset in a taxable account, be cognizant of the cost basis and the capital gain or loss that will be triggered by the sale. Manage your gains and losses (your winners and losers) by capturing a loss in an asset that has declined in value and using that loss to offset gains from selling other assets. This is called *tax-loss harvesting*. When selling an asset with a gain, hold the asset for at least one year so it will be categorized as a *long-term* capital gain, making it eligible for the preferential capital gains tax rate. Also, minimize transaction fees from trading.
- Consider making charitable contributions using appreciated securities rather than cash. This eliminates the capital gain taxes on the asset that is donated to charity.
- When rebalancing or taking withdrawals from a taxable account, be aware of the tax consequences of selling different assets.

With the tax changes effective January 1, 2013, attempting to keep your adjusted gross income from going above certain thresholds is wise. The tax changes have a compound effect on high income earners. In accounting parlance, the taxes are "stacked," meaning one tax increase can trigger another. For example, the new taxes for high income earners can push you over an adjusted gross income thresh-

old so you start losing exemptions and deductions. That will cause your taxable income to increase, and force you into a higher tax bracket. If you know you are vulnerable to exceeding the thresholds that trigger higher taxes, you may want to work with your tax advisor or financial planner to strive to minimize your taxes.

Let's go back to the saying "Don't let the tax tail wag the investment dog." Paul Sullivan wrote an article for the *New York Times* about *unwise* investment decisions to avoid or defer taxes. One common example is not selling individual stocks simply to avoid paying the capital gains tax. If the stock represents a concentrated position in your portfolio (concentrated is typically defined as over 10 percent but may be only 5 percent), then a portion should be sold to reduce the risk that the share price may plummet. Not selling the stock simply to avoid paying the capital gains tax can be a very unwise decision. Sullivan's article also talks about deferred compensation plans, which are often made available to corporate executives. Unlike money contributed to a 401(k) plan—which is protected if a company goes bankrupt—deferred compensation plans do not have the same protection. The money in deferred compensation plans becomes subject to creditors, meaning the individual investor may not receive the money or may only receive a portion of it. Other examples of tax avoidance or tax deferral investments that may be unwise include investments in green energy, limited partnerships, section 1031 real estate exchanges, and even annuities. The bottom line: *Sometimes it is better to pay your taxes and focus on maximizing the after-tax money.*

The Extraordinary Roth IRA

The Roth IRA is one of the greatest gifts Congress has given investors over the past 20 years, and it has multiple features and benefits. I strongly encourage you to take advantage of this very versatile investment tool.

The concept of the Roth IRA was proposed by Senator William Roth in 1997 and became available to investors beginning in 1998. The Roth IRA was originally intended as a retirement savings tool, in which the contributions and growth of the assets within a Roth IRA are *tax-free* when withdrawn, rather than *tax-deferred* as in a traditional IRA. The primary purpose continues to be for retirement, but many other benefits have become apparent during the past 15 years. The Roth IRA is a magnificent estate planning tool because beneficiaries receive the assets income-tax free, and it works great as a first investment account for teenagers and young adults.

Building a Roth IRA Tax Bucket

There are three primary ways to build a Roth tax bucket:

1. Contribute to a Roth 401(k) or Roth 403(b) through your employer.
2. Convert a traditional IRA to a Roth IRA or a traditional 401(k) or 403(b) to a Roth 401(k) or Roth 403(b). (This requires paying taxes on the amount converted in the year of the conversion.)
3. Open a Roth IRA account and make annual contributions.

Unfortunately, there are income limitations that prevent some investors from contributing directly to a Roth IRA. The income limitations for 2013 start at $178,000 for a married couple and $112,000 for a single person. (These income limitations apply to modified adjusted gross income. See the IRS website at www.irs.gov for a definition of modified AGI). These income limitations change slightly from year-to-year, and current figures can be accessed from the IRS website. Fortunately, contributing to a Roth 401(k) or Roth 403(b) through your employer does not have income limitations, and converting a traditional IRA to a Roth IRA or a traditional 401(k) or 403(b) to a Roth 401(k) or Roth 403(b) does not have income limitations.

Are There Exceptions?

Yes! There are always exceptions. Tax strategies and Roth IRA strategies must be customized to each person, so there are plenty of exceptions. For example, although I look for all opportunities to convert a client's traditional IRA to a Roth IRA (without triggering unjustified taxes), some financial advisors prefer to not do Roth conversions. Their rationale is that they hope the person will be in a lower tax bracket when they retire, and they may convert to the Roth IRA at that time. I disagree, and prefer to take advantage of the future tax-free benefits of the Roth IRA as soon as possible.

There are also exceptions regarding the "backdoor Roth IRA." Some financial advisors recommend it for all of their high-income clients, and other advisors do not recommend it at all. Yes, there are exceptions.

Beginning in 2010, anyone can convert any amount from a traditional IRA to a Roth IRA. Prior to 2010, persons with over $100,000 in income were prevented from doing a Roth conversion.

If you are not already contributing to a Roth IRA (and your income does not exceed the income limitations shown above), I strongly recommend you open an account and start contributing. You can contribute the maximum amount allowed to a 401(k), 403(b), Roth 401(k), or Roth 403(b) through your employer and also fund a Roth IRA. The maximum contribution amounts allowed for Roth IRAs in 2013 is $5,500 for a person under age 50 and $6,500 for persons age 50 and over. Refer to the IRS website for current figures in future years.

There is a fourth way to build a Roth IRA tax bucket, but it only works in limited circumstances. If your income is too high to con-

tribute directly to a Roth IRA, you may still be able to fund a Roth IRA via a "backdoor Roth IRA." This strategy works best for investors who do not have a large traditional IRA. Often, a person who is not retired will have accumulated a large 401(k) account, but they will not have a traditional IRA.

The backdoor Roth IRA involves contributing to a traditional IRA on an *after-tax* basis (there is no tax benefit in the year of the contribution), and then converting that amount to a Roth IRA. (I prefer doing the conversion to the Roth IRA in the same year as the contribution, but this is not required). Because the IRA contribution was on an after-tax basis, the amount of the contribution is considered as basis and is not taxable when converted to the Roth IRA. This strategy is not discussed in detail in this book, but you can find articles explaining the process by searching online for "backdoor Roth IRA." I use this strategy for my high-income clients who often have large 401(k) accounts but do not have large traditional IRAs.

Contributing to an Employer's Roth 401(k) vs. a Traditional 401(k)

Many employers have introduced Roth 401(k) plans and Roth 403(b) plans in recent years as a choice within their employee retirement plan. The tax consequences are very different from contributions made into traditional 401(k) plans and 403(b) plans.

If you contribute to a traditional 401(k) plan, your contribution will be pre-tax, which means that the contribution is *not* included in your taxable income for that year. Conversely, if you contribute to a Roth 401(k) plan, the contribution is after-tax, and it is included in your taxable income in the year you make the contribution. In the short term that appears to be a negative feature. However, the money contributed to the Roth 401(k) plan (and the earnings over future years) will not be taxed when you withdraw it. The long-term benefits of a Roth 401(k) outweigh the benefits of a traditional 401(k). Most of my working clients who are in a 28

percent or higher federal tax bracket are directing at least 50 percent of their 401(k) contributions into the Roth 401(k). (The remaining 50 percent is still going into the traditional 401(k) to provide an annual tax benefit.) If you are in a marginal tax bracket lower than 28 percent, then I recommend directing your *entire* contribution to the Roth 401(k) due to the attractive long-term benefits.

Regardless of whether your contributions are being directed to the traditional 401(k) or the Roth 401(k), many employers will match a portion of your contribution. This is extremely valuable, and at the very least, you should contribute the amount that your employer will match. Ideally, you should contribute the maximum allowed.

When to Convert a Traditional IRA to a Roth IRA

The best conversion strategy is to look for a window of opportunity when your tax bracket will be low and do a Roth conversion in that year. You can convert any amount each year, so converting gradually over many years can work well. Converting to a Roth IRA gradually may allow you to stay in a low tax bracket. Conversely, if you expect tax rates to go up significantly in future years, you may want to convert a significant amount before tax rates increase.

Young investors reap the maximum benefits of a Roth conversion because they have so many years for the Roth IRA to grow tax-free. Another strategy would be to convert money gradually from your IRA to the Roth IRA between ages 60 and 70. The taxable account could be used to pay the taxes each year. This strategy works well for investors who are eager to move money from the traditional IRA into the Roth IRA. Traditional IRAs require distributions after age 70½ (these are called Required Minimum Distributions, or RMDs). Roth IRAs do not require RMDs at age 70½. Therefore, any money moved to the Roth IRA prior to age 70½ is not included in the calculation for the RMD, thereby making the RMD lower than if the Roth conversion had not occurred.

Another opportunity for a Roth conversion is between retirement and when you start drawing Social Security benefits. This works well if Social Security benefits are delayed until your full retirement age or later.

Each person's situation is different, and there are many variables to consider. The strategy needs to be customized to match your specific situation. Having money in different buckets with different tax treatments provides you with more choices. The key is to manage your tax rate and to convert from a traditional IRA to a Roth IRA whenever it provides future benefits that exceed the taxes you would be required to pay in the year of conversion. It is best to consult with your financial planner or tax advisor on your specific situation.

The beauty of the Roth IRA (or Roth 401[k]) is that it is tax-free going forward. The longer it is left in the account to grow and compound tax-free, the more powerful the tax-free provision becomes.

Reasons Not to Convert to a Roth

- If you anticipate your tax rate going down, you may choose not to do a Roth conversion.
- If your tax rate is currently very low (and you expect it to stay very low), then a Roth conversion is unnecessary.
- If you do not have the money in a taxable account to pay the taxes due to the Roth conversion, you should avoid a conversion. Paying the income taxes from additional IRA withdrawals significantly reduces the benefit of a Roth conversion.
- If you intend to spend all your assets or you do not have any children as beneficiaries, then the estate planning benefits of the Roth IRA are eliminated.

The Versatile Roth IRA

Roth IRAs are very versatile, offering numerous benefits. This section provides information on the primary and secondary benefits.

Primary Benefit: Retirement

Roth IRAs are retirement accounts, so the money is typically not withdrawn until at least age 59½. Often, an investor will plan to tap into a Roth IRA as a last resort, because allowing the tax-free money to compound over many years is a major benefit.

When a person contributes to a Roth IRA, there is not an immediate tax benefit. You cannot take a tax deduction in the year you make the contribution. You must have *earned income* to contribute to a Roth IRA, and earned income typically includes wages, salaries, and tips. Rental income, disability income, pension income, Social Security benefits, dividends, and interest are *not* considered earned income.

If one spouse is working and has earned income and the other spouse does not work, *both* spouses can still contribute to their Roth IRAs.

When dealing with Roth IRAs, it is important to discuss the contributions separately from the earnings because they are handled very differently from a tax standpoint. Let's first review the contributions. Because there is not an immediate tax benefit when you contribute to the Roth IRA, the contributions can be withdrawn tax-free at any time. For example, if you contribute $5,000 each year for 10 years to a Roth IRA, your contributions will total $50,000. If the account has grown 8 percent per year, the total account at the end of 10 years will be over $78,000. You can withdraw the $50,000 (your total contributions) at any time and leave the $28,000 of earnings in the account until you turn age 59½. The ability to withdraw the *contributions* at any time makes the Roth IRA more flexible than a traditional IRA, which requires you to leave contributions *and* earnings in the account until age 59½ to avoid a penalty.

In terms of *earnings*, keep in mind that the Roth IRA is meant for long-term savings and investing. That means you are required to keep the earnings inside the Roth IRA for at least five years. The five years begins on the first day of the first year for which

contributions are made, and only one five-year holding period is required, regardless of future contributions. For example, if a person opened a Roth IRA and contributed $5,000 on November 1, 2010, the five-year holding period would have started on January 1, 2010 and concluded on January 1, 2015. The earnings within the Roth IRA can be withdrawn tax-free as long as the five-year holding period is met, *along with one of the following*:

- The taxpayer's age is at least 59½
- The distribution is due to death or disability
- The distribution is made to a qualified first-time homebuyer

If you withdraw the earnings after meeting the above rules, the withdrawal is deemed to be a *qualified* distribution of earnings. If you take a *nonqualified* withdrawal, the earnings are taxed and you will incur a 10 percent early withdrawal penalty if you are under age 59½. The moral to this story is that the contributions are always accessible to you (for any reason, with no penalties), but the earnings should be left in the account for at least five years *and* until age 59½.

Another enormous benefit of the Roth IRA is that withdrawals are not required to begin at age 70½ like a traditional IRA requires. Because withdrawals are not required, the money can stay in the account growing and compounding tax-free for many years. Many retirees find they do not need money from their traditional IRA at age 70½. They may have plenty of money from other sources (such as Social Security, a pension, or a taxable investment account) to cover their living expenses. Yet the traditional IRA requires that distributions begin when a person turns 70½. At that point, the RMD triggers income taxes on the amount withdrawn each year. As a general rule, the RMD is slightly less than 4 percent times the value of the IRA at the end of the prior year. As a person gets older, the 4 percent increases slightly each year. (See www.irs.gov for details.)

The fact that the Roth IRA does not require distributions at age

70½ is an enormous benefit. For retirees who don't need withdrawals for their living expenses, they can leave the money in the Roth IRA to continue growing tax-free and potentially leave it to their heirs to continue growing tax-free for many more years.

Secondary Benefit: Estate Planning

From an estate-planning standpoint, a Roth IRA is a valuable account to leave to children, grandchildren, or other beneficiaries. The beneficiary will not be required to pay income taxes on the distributions from an inherited Roth IRA as they would on distributions from an inherited traditional IRA, although they must take annual withdrawals based on their age and IRS rules. In this respect, leaving a Roth IRA to a beneficiary is more favorable than leaving a traditional IRA.

However, if a person is planning on leaving a part of their estate to a qualified charitable organization, then a traditional IRA is typically the best asset to leave, because the charitable organization is not required to pay income taxes. If a person has a traditional IRA as well as a Roth IRA, it would be best to leave the traditional IRA to a charitable organization and leave the Roth IRA to a child, grandchild, or any other person.

Additional Secondary Benefit: Teenage Savings Account

Roth IRAs are fabulous for teenagers with jobs, such as babysitting, mowing lawns, etc. The income must be categorized as "earned income." Earning an allowance does not count. However, if a parent paid a child (any age) to clean out the garage or wash the windows, this would be acceptable. A child can contribute the amount of their earned income, up to the $5,500 maximum Roth contribution for 2013, if their earned income is $5,500 or higher. Although it may not be required, I recommend that the income be substantiated by

filing a federal tax return for the child or teenager. If the child does not receive a W-2 form or a 1099 form from an employer, then it is very important to keep clear records showing the dates the child worked, the hours, and the amount paid. Also, if the child does not receive a W-2 form from an employer, Social Security taxes *may* need to be deducted when calculating the amount of the Roth contribution.

Because the Roth IRA is such a valuable savings and investing tool, and because it is even more valuable when started by a child or teenager (due to the many years the investments will have to grow and compound on a tax-free basis), I often recommend that parents or grandparents fund a Roth IRA for their child or grandchild. For example, if a teenager earns $1,200 per year, he will not want to invest the entire $1,200. Let's assume he saves 20 percent of it for school trips or upcoming college expenses (starting a lifelong habit of saving 20 percent as mentioned in Chapter Seven, "Family Issues"). The parent or grandparent can gift $1,200 to the child (the amount the child earned), and the $1,200 can be contributed to a Roth IRA. It is not necessary that the actual money the child earned be contributed to a Roth IRA. The key is that the amount earned (up to $5,500 per year for 2013) is the maximum amount the child can contribute to the Roth IRA. Therefore, contributing gifted money to the Roth IRA (that matches but does not exceed the child's earnings) is acceptable—and wise.

Note: The information provided on Roth IRAs is based on current tax laws. The Roth IRA is extremely attractive because of its tax-free growth provisions, its flexibility in withdrawing contributions at any time without penalty, and its lack of required distributions at age 70½. There are many minute details involved in Roth IRAs, and the rules may change. For example, there is currently a proposal in Congress that would force beneficiaries to withdraw money in an inherited Roth IRA (or traditional IRA) within five years. This would eliminate one benefit of the Roth IRA (and traditional IRA), which is the "stretch" provision which

allows beneficiaries to withdraw the money over many years. However, the other benefits would remain. It is unknown whether such a proposal may pass, or whether prior Roth IRA owners would be "grandfathered" under the old rules.

Invest in Yourself

- Are you funding all three tax buckets (tax-deferred, taxable, and tax-free accounts)? If not, refer to the net worth statement you created in Chapter Seven, and determine how much you have in each tax bucket. Decide how you can start funding all three buckets.
- Are your taxable investment accounts tax-efficient? (See "More Tax Strategies" earlier in this chapter.)
- Are you taking advantage of the extraordinary Roth IRA? Have you considered converting a traditional IRA to a Roth IRA for the potential long-term tax savings?
- Are you helping your child or grandchild fund a Roth IRA (as long as they have earned income that is properly documented)?