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Best Planning Ideas for 2012

A special panel discussion, "Best Planning Ideas 2012," was held during the Advanced Personal Financial Planning (PFP) Conference this past January. Participating in the panel were Robert S. Keebler, CPA, MST, AEP (Distinguished); Michael E. Kitces, MSFS, MTAX, CFP®; and Daniel S. Rubin, JD, LLM (Taxation). The following are the highlights of the discussion, arranged topically. See the sidebar for links on how to obtain a video recording of this session.

Political and Economic Uncertainties

The upcoming presidential election creates significant uncertainty for planners and their clients, and those challenges are addressed at length in the article, "Practitioner Roundtable: Proactive Planning Ideas and Practice Management Trends" on page 1. Financial planners must also grapple with overall economic uncertainty driven by the possibility of a European debacle, the expectation of mediocre long-term yields, and significant pricing and player changes in the insurance sector. Portfolio planners must seek new ways to invest that will address the risk of extreme events by creating innovative pivot points that will allow clients—and our practices—to adjust to uncertainty, change, and potential declines.

Loss Harvesting

When addressing loss harvesting and gain harvesting, planners should always start with basic economics. The wash sale rule prevents clients from claiming a loss on the sale of a stock if they buy a replacement stock within 30 days before or after the sale. Planners have been working with clients to match gains and losses and short- and long-term positions, and to do that, planners must take care to track how those variables net out.

A number of more sophisticated strategies are also available, including the following:

- The double-up approach that may help reduce risk for larger positions
- The short-against-the-box transaction that is still available under the wash sale rules, provided you take the collar off the position once a year for 30 days
- Pushing a long-term capital loss into a purchased call option, and then closing that option position within 30 days to convert that long-term capital loss into a short-term capital loss

Harvesting in a Rising Tax Environment

This is something planners have preached to clients since 2008: in a rising tax environment, planners should think about harvesting capital gains instead of losses. In a world in which tax rates are stable or trending down, the standard tax advice is to defer income and take deductions in order to avoid paying any more tax than necessary. Conversely, in a world in which taxes are rising, planners should advise clients to take income now and to pay taxes at today's presumed lower rates. Deductions should be deferred to be used against the future's higher expected tax rates.

Although paying taxes sooner can be a difficult conversation to have with clients, the advantages of harvesting gains now are counterintuitive, but very real. These principles also apply to dividends: if a client owns a closely held C corporation with earnings on the books, he or she can take money out this year and pay 15 percent, or wait 12 months and pay as much as 43.4 percent. Even factoring in uncertainty and client reluctance, that kind of harvesting makes sense.

Portfolio Drawdown Rates

Portfolio drawdown has also been a critical issue since 2008, and two questions are particularly crucial: (1) For a client with a given portfolio value, how much can be sustainably withdrawn, and

More Planning Resources

If you missed "Best Planning Ideas 2012" during the 2012 Advanced PFP Conference, registered attendees may access the video and audio recording and presentation materials at the AICPA's Online Library. Registered attendees for the 2012 conference have complimentary access when they log in through the website. Conference attendees should click here for instructions on how to access the materials. Those who did not attend can create an account to purchase audio recordings and presentation materials.

For a related discussion of state estate taxes, see "How Soon Will States Close Their Estate Tax Loopholes?" by Michael Kitces, on page 7. In addition, see Sheryl Rowling's article, "New Cost Basis for Mutual Funds," in *Planner's* March/April issue.

On May 9, 2012, Lyle Benson, CPA/PFS, CFP®; Ted Sarenski, CPA/PFS, CFP®; and Scott Sprinkle, CPA/PFS, CFP®, presented "Proactive Planning Ideas in Preparation for 2013," an informative online seminar on looming income, and estate, and gift tax changes for 2013; the impact of the political environment; and much more. PFP Section members may access the archived online seminar and presentation materials at the PFP Web Seminar Library.

(2) how can planners manage investments to improve that sustainable number?

The traditional safe withdrawal rate was 4 percent, but as portfolios diversified, the advisable drawdown rate discussions moved to the 4.5 percent and even 5.5 percent range. Clients have also proven to be more dynamic and proactive and are willing to make appropriate adjustments in hard years, which helps to sustain higher starting withdrawal levels.

On the investment management side, research shows that even if you have decent long-term average growth in a portfolio but have a bad sequence of returns early on, many portfolios simply cannot recover. By dampening volatility—sacrificing a bit of upside to reduce downside potential—clients end up with more income over the life of the portfolio, even if returns are not higher. As a result, tactical asset allocation can be a tool to enhance sustainable retirement income, even if it does not increase returns.

Drawdown Tax Implications

In today's complex and dynamic environment, the tax ramifications of asset drawdown is a difficult issue and, unfortunately, there is not a great deal of current research on the issue. Most clients have varied portfolios that may include mutual funds, IRAs, Roth IRAs, brokerage accounts, annuities, life insurance, stock options, and pension plans. From a tax perspective, the basic principle calls for spending outside of the portfolio first, followed by the IRA, and then the Roth IRA. Planners should recognize that every client is unique, and by getting the order of asset drawdown right, you can add years to the longevity of a retirement portfolio. The accounting profession is currently working on developing good rules of thumb to guide this important process.

Trends and Ideas

Prenuptial Agreements. Prenuptial agreements can be very helpful because they encourage people to talk about key financial possibilities before they get married. Yet, these agreements can be cumbersome, and some soon-to-be-spouses are simply not open to this kind of conversation. Fortunately, an alternative exists. By setting up a trust, clients can segregate some portion of their wealth; because that trust would not be marital property, the portion would not be subject to equitable distribution by a judge in the event of a divorce. Certain states offer trust rules that protect property set aside in trust prior to the date of the marriage. This strategy can be helpful when a prenuptial agreement is not an option.

Cost Basis Reporting. Important changes are now in effect that regulate how financial intermediaries report securities transaction cost basis information to the IRS, and more changes are coming in the next few years. Although these changes were viewed as fine print provisions of legislation enacted during the 2008 financial crisis, they have major implications for planners and clients that are just now coming to bear.

Basically, financial intermediaries that issue a Form 1099 must now, in addition to reporting gross proceeds, also include information on cots basis, gain, and the character of the gain. These rules only apply to new purchases of stock, mutual funds, and other assets going forward. As time passes, a growing number of positions will be affected. Eventually, everything needed for a Schedule D will be reported on the Form 1099. The serious planning issue for clients is that custodians must assign a method of accounting at the time of the sale, so advisers must understand the rules to make a proactive method of accounting decision up front, while being aware of how various accounting methods might affect a particular client.

Roth Conversions. The thinking about using Roth IRAs as a planning tool has changed since the Roth IRA was first created in 1998. The current emphasis is shifting away from tax toward financial strategies. While planners were once very careful about making bad long-term decisions relating to Roth IRAs, with today's well-understood rules on recharacterization privilege following the year of conversion, planners are no longer talking about conversion or recharacterization. Instead, planners are talking to clients about reconversion, which means if a Roth IRA starts at $100 and falls to $80 in value, they are recharacterized and can jump back in at $80 following the reconversion rule.

In a time of expected tax rate increases, most clients should take mutual funds and convert to a Roth. However, planners should not worry; if the value goes up, the client wins. If it goes down, the client can re-characterize. Roth conversions can also be used to address the needs of that small group of clients exposed to the Medicare surtax bubble.

This article was originally published in the AICPA Planner newsletter. This newsletter is exclusive to members of the AICPA Personal Financial Planning (PFP) Section. The PFP Section provides advocacy, education and resources to practitioners who specialize in providing estate, retirement, tax, investment and/or insurance planning advice to their individual clients.