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All Things Financial Planning

by Jason Foster, Director of Financial Planning, Attorney

Hello!

Our planning team appreciated the overwhelmingly positive response we received from you regarding our first financial planning newsletter sent out in August. We certainly enjoyed collaborating in putting it together. If you missed the 2019 3rd Quarter edition, or would like to access it, you can find it on our website at colofinancial.com, or email me directly at jason@colofinancial.com and I will send a copy to you.

As 2019 winds down, there are a number of year-end planning considerations your advisor or planning team will likely be discussing with you in the next few weeks. We have provided a list of these planning actions in the first article of this newsletter. Please review to decide whether any of them should be a part of your year-end planning. The accompanying deadlines are provided to make sure the action will be recorded for 2019.

We hosted our first financial planning topical meeting on estate planning basics in Denver on November 7th and we have similar events planned in both Johnstown, on November 21st and Boulder, on December 5th. We still have a few spots left for the Johnstown event and are nearing capacity at our Boulder venue. Let us know as soon as possible if you plan to attend. For the estate planning discussions, we have reserved local estate planning attorneys to take part in the conversation at each location. The current plan is to have a new topic and dates for the first quarter of 2020, and similarly invite a local professional to share their knowledge with you. Stay tuned for this announcement.

Outside of providing the year-end planning initiatives and deadlines, this quarter's newsletter will include an article on how Donor Advised Funds (DAFs) work, and the second part of a discussion on Roth IRAs, with a focus on the conversion of IRA money to Roth money. I hope you find these subjects informative and helpful.

"I retire on Friday and I haven't saved a dime. Here's your chance to become a legend!"

Year-End Financial Planning Actions and Deadlines
by Tim Dutton, Associate Financial Planner

It's time to consider year-end planning decisions that will better position you financially in 2020 and beyond. Below is a list of actions and deadlines we have compiled worth reviewing for applicability. If you have any questions regarding whether any of these strategies or actions would make sense for you, do not hesitate to contact us.

Retirement and Medical Expense Account Planning

Fund Retirement Accounts. Make contributions to Qualified Defined Contribution Plans, Tax Advantage Plans and IRAs to take advantage of current year deductions and tax-deferred growth within the account. ***IRA, SEP IRA and employer contributions must be made by April 15th. Employee contributions to 401ks, Solo 401ks, and Simple IRAs must be made by December 31st.***

Contribute to a Health Savings Account. Max out tax deductible contributions to your HSA. Earnings within an HSA are not taxable, and amounts distributed from an HSA are also not taxable provided the distributions are used for qualified medical expenses. Distributions from an HSA prior to age 65 for non-medical expenses are subject to income taxes, plus an additional 20% excise tax penalty. ***Contribution deadline is April 15th.***

Spend Available Flexible Savings Account Money. Contributions to an FSA are tax deductible to an employee, much like an HSA account. Unlike an HSA, if the employee fails to use all contributed amounts within a certain period, usually the end of the year, contributions are forfeited back to the employer (use it or lose it). ***Check with your plan sponsor as deadlines may vary depending on the plan.***

Roth Conversion. An individual may convert a Traditional IRA to a Roth IRA to enjoy tax free growth and distributions. The amount converted, however, will be included in their taxable income. Funds in a Roth IRA are not subject to RMDs and conversions are a great strategy for those expecting to pay higher marginal tax rates in the future. (For more on whether a Roth conversion might make sense for you, please review considerations detailed in the last article of this newsletter.) ***Roth conversions must be made by December 31st, but the analysis on whether to convert Traditional IRA money, or how much to convert, should begin much sooner.***

Take RMDs. Required Minimum Distributions apply to assets in a qualified plan, IRA, Qualified Annuities, 403(b), SEP, SIMPLE, or 457 plans. While minimum distribution rules do not apply to Roth IRAs, they do apply to Roth accounts in a 401(k) or 403(b). The first distribution must be taken by April 1st of the year following the year the participant attains the age of 70½. For each year thereafter, the RMD must be taken before December 31st of the tax year. ***Assuming you are beyond your initial RMD payment, full RMDs must be taken by December 31st.***

Charitable Planning

Turn your Required Minimum Distribution into a Qualified Charitable Distribution. A QCD is a direct transfer of funds from your IRA custodian, payable to a qualified 501(c)(3) charity. QCDs count toward satisfying your RMDs for the year, if certain rules are met. The QCD amount is excluded from taxable income, unlike regular withdrawals from an IRA. The maximum annual amount for a QCD is $100,000. ***The deadline for making QCDs coincides with RMDs, and is December 31st.***

Contribute to a Donor Advised Fund. DAFs are accounts established at firms such as Charles Schwab and Fidelity to facilitate charitable contributions while receiving an immediate income tax deduction. You can contribute to the fund as often as you like, and then recommend gifts to your favorite charities whenever it makes sense for you. A direct donation of publicly traded securities (or other illiquid assets) can be a highly tax efficient way to fund a DAF to potentially avoid capital gains tax on the appreciated assets. (For a more comprehensive presentation on DAFs, please see the next article in this newsletter.) ***Deadlines for year-end contributions vary, depending on method and types of assets. Contact your advisor in early December to make sure all asset and contribution options remain available to be processed before the end of the year.***

Charitable Rebalance. A charitable contribution of long-term appreciated assets can be one of the most tax-efficient ways to give and simultaneously rebalance your investment portfolio. Over time, long held positions in a stock can create substantial unrealized gains and overweight the portfolio. With a charitable rebalance, you can donate a highly appreciated stock position to a charity or DAF, allowing for both the exclusion of unrealized capital gains and a qualifying charitable deduction. From here you can purchase new shares of the same highly appreciated stock or other assets to rebalance the portfolio. ***Final deadline for gifting is December 31st, but the planning and process should be started well in advance.***

Wealth Transfer Considerations

Make Annual Gifts. The annual gift tax exclusion allows you to gift to up to $15,000 per donee per year ($30,000 if "split-gift" elected between spouses) without having to file a gift tax return. Gifting over these amounts will require a gift tax return to be filed, but no taxes would be owed unless you have gifted more than the unified exemption amount ($11.4 million for individuals and $22.8 million for spouses for 2019). The amount gifted over the annual exclusion amount simply reduces the available unified exemption for tax free gifting during life and at death. If your estate could be subject to estate tax, gifting is a great way to reduce your gross estate. ***Gifts must be made on or before December 31st. The deadline for filing a 709 Gift Tax Return is April 15th.***

Fund a 529 College Savings Plan. If you reside in Colorado, every dollar you contribute to a Colorado 529 plan can be deducted from your state income tax return. Once contributed, the funds in the account grow tax free and are distributed tax free if used for qualified higher education expenses. Contributions to 529 accounts are also considered a completed gift for federal gift and estate tax purposes. A special rule allows individuals to contribute up to $75,000 (5 Years x $15,000) in one year, without any gift tax consequences. A couple electing "gift-splitting" can contribute double this amount, or $150,000. ***Contributions to 529s must be made by December 31st.***

Investment Portfolio Decisions

Tax Loss Harvesting. Investment losses can help you reduce taxes by offsetting income or gains. Even if you don't currently have any gains, there are benefits to harvesting losses now, since they can be used to offset income or gains in future years. If you have more capital losses than income or gains, you can carryover up to $3,000 of losses to offset income or gains in future years. ***Final deadline for tax loss harvesting is December 31st, but planning should be done well in advance.***

The Mechanics of a Donor Advised Fund and When It Makes Sense to Utilize One
By Victoria Falus, Senior Financial Planner, CFP

A Donor Advised Fund, or DAF, is a charitable giving vehicle administered by a public charity created to manage charitable donations on behalf of organizations, families, or individuals. A DAF is a little like a personal charitable savings account. They are simple to establish and administer and can be a tax-smart investment solution for charitable giving.

The Basics. To establish a DAF, a donor creates an account and makes a contribution of cash, (appreciated) stock, or other assets like real estate or artwork to the account. These accounts are controlled by a sponsoring organization that invests the assets in the account. Community foundations, such as the Denver Foundation or Community Foundation for Boulder County often serve as a sponsoring organization. Nonprofit arms of financial-services firms, such as Schwab Charitable and Fidelity Charitable, are also great options, especially if you already have accounts set up at either of these firms. The funds within the DAF can either be granted immediately to any IRS-qualified public charity OR they can be invested for tax-free growth and granted to any qualified public charity at a future date. Contributions to a DAF account are irrevocable once they are made and are controlled by the sponsoring organization. Donors can contribute to the fund as frequently as they like and can recommend grants to their favorite charities when it is convenient for them.

Tax Treatment. As soon as you make a donation, you are eligible for an immediate tax deduction, the same as if you donated directly to a public charity. The tax deduction and benefit you receive may be effected by the type of donation. For a *cash donation*, you are generally eligible for an income tax deduction of up to 60% of your adjusted gross income (AGI). If you donate *long term appreciated assets*, such as stocks, bonds or real estate, you get a tax deduction of up to 30% of your AGI, but get the added benefit of not having to pay capital gains on these assets if the assets were separately sold by you. If they are sold in the DAF, no capital gain is realized.

Benefits and DAF Strategies. The following is a list of various benefits and strategies regarding donor advised funds:

- Recordkeeping and management are simplified. Instead of tracking down receipts and your separately made charitable donations, the sponsoring firm will manage the accounting and provide you with everything you need for tax reporting. Your financial advisor can manage the assets in the account in a similar fashion as the assets in your portfolio, helping grow the fund prior to granting the money out to benefit your selected charities.
- DAFs allow you to effectively pre-fund years of giving with assets from a single high-income event. This strategy can reduce tax burdens after a situation involving a windfall, such as receiving an inheritance, selling a business, or receiving a large, unexpected gain. It could also be utilized in a combined strategy to alleviate income taxes associated with a Roth conversion.
- As discussed earlier, direct donations of appreciated stocks and securities is one of the most common ways to fund a DAF. Because securities that have been held for more than one year can be donated at fair

market value and avoid capital gains tax, it can be a particularly tax efficient strategy. If a donor were to liquidate these appreciated assets first, and later donate the proceeds to a DAF, the net amount would be reduced by capital gains tax, leaving less money available for philanthropy. Below is an illustration of the benefit to donating highly appreciated assets vs. cash:

Asset Value (FMV)*	1,000 shares @$55 per share = $55,000	1,000 shares @$55 per share = $55,000
Capital Gains (100% Long-Term) Assumes a cost basis of $5,000 and long term capital gains of $50,000	$50,000	$50,000
Capital gains tax paid (23.8%, includes 3.8% net investment income tax)	$11,900	$ 0
Value of Gift to Charity (How much the charity will receive after taxes)	$43,100	$55,000 ($11,900 more for charity)
Value of charitable deduction (Assumes donor is in the 37% federal tax bracket)	$15,947	$20,350 (The donor's federal income taxes are reduced by $4,403)
Donor tax savings (Value of deduction less capital gains tax paid by donor)	$4,047	$20,350

With a direct donation to charity or a donor-advised fund account, the donor's federal income taxes are reduced by $4,403 and the charity receives $11,900 more.

Hypothetical, for illustrative purposes only. Assumes cost basis of $5,000, that the investment has been held for more than a year and that all realized gains are subject to the 20% federal long-term capital gains tax rate plus the 3.8% Medicare net investment income surtax. Does not take into account any state or local taxes. Gifts to charity of restricted stock greater than $10,000 are typically deductible at fair market value as determined by a qualified appraisal. Such appraisals may be discounted to reflect the lack of immediate marketability and other restrictions. Such discounts vary widely, depending on the nature of the specific restrictions. A 20% discount was assumed for this example. The example assumes full deductibility (gifts of long-term property are generally limited to 30% of AGI with a 5-year carryover of unused amount). Assumes donor is subject to the maximum 37% federal tax and does not account for state or local taxes. Certain federal income tax deductions, including the charitable contribution, are available only to taxpayers who itemize deductions, and may be subject to reduction for taxpayers with adjusted gross income (AGI) above certain levels. In addition, deductions for charitable contributions may be limited based on the type of property donated, the type of charity, and the donor's AGI.

**Illustration courtesy of Schwab Charitable*

The middle column above represents someone who has sold appreciated stock prior to a donation to the DAF. The right column represents a client who donated the appreciated stock prior to selling. Notice the significant difference in the value of the gift and donor tax savings involving the two approaches.

Itemizing Strategies Involving DAFs. Charitable contributions remain deductible to taxpayers that itemize their deductions. Under the Tax Cuts and Jobs Act of 2017, a much larger standard deduction is now in place. Single filers may now claim a $12,000 standard deduction, while married couples filing jointly can claim a $24,000 standard deduction. But tax payers who itemize can still take advantage when their itemized deductions exceed the available standard deductions. With charitable contributions, such as those made to a DAF, individuals can concentrate and itemize their charitable contributions in higher income years and then benefit from the increased standard deduction in other years.

For example, let's say a married couple has $23,000 of itemized expenses in a particular year, including an $11,000 donation to a qualified charity or DAF. Because that amount is below $24,000, they would claim the $24,000 standard deduction for that year. But there is a more tax-advantaged approach if the couple plans to make the same $11,000 donation to charities in consecutive years. Instead of donating $11,000 to charity each year, the couple could concentrate, or bunch, their charitable donations, applying them all to a single year. The concentrated donation creates a total of $34,000 in itemized deductions for a tax year. Taking the standard $24,000 deduction in the first year, and the $34,000 concentrated donation in the second year, the couple would have $10,000 of additional deductions over a two-year period, resulting in increased tax savings.

* * *

Giving season is an ideal time for individuals to evaluate their philanthropic activities. Donor Advised Funds offer thousands of charitable options, including local and socially responsible choices to invest in to fulfill your charitable needs. To make sure that your gifts are processed on time, it is best not to wait until the final weeks of the year to start a giving strategy. Individuals who already have DAF accounts and want to grant gifts in 2019 should consider scheduling now to ensure they are approved and can be sent out well in advance of year-end. If you are interested in setting up a DAF in 2019, you should consider starting the process as soon as possible to allow enough time for processing. If you need assistance, our CFM team is available to answer any questions and can help with any part of the process.

"WE HAVE MUTUAL FUNDS . . . MY MONEY IS HER MONEY."

Roth IRAs (Part 2) – Is It a Good Time to Consider Converting Some IRA Money to Roth Money?
by Jason Foster, Director of Financial Planning, Attorney

In the August letter, we explored the basics behind an IRA Roth, including the benefits of allowing money contributed to a Roth to grow tax free without being forced to take required minimum distributions unless the account was inherited. We also discussed rules defining income levels associated with the ability to contribute, the 5-year vesting requirement to avoid penalties and taxes on any gains, the age requirement of 59 ½ for tax free withdrawals of principal and gains, and some notable exceptions to these withdrawal rules.

Many clients might otherwise be phased out of the ability to contribute to a Roth based on the income thresholds ($137,000 for individuals and $203,000 for married couples for 2019). But the IRS has formally adopted the method of allowing high-income taxpayers the ability to convert money from an IRA to a Roth.

This article will focus on factors and circumstances to consider when contemplating a conversion of IRA money to Roth money. Keep in mind – converting IRA money is not a tax dodge. Roth money is *after* tax money and IRA money is *pre*-tax money. You will either pay taxes for the tax year in which you convert, or later when you withdraw the money from your traditional IRA. So let's start here – when is conversion the right answer from a tax perspective?

In simplest terms, a traditional IRA will produce the same after-tax result as a Roth IRA provided that: 1) the annual growth rates are the same and 2) the tax rate in the conversion year is the same as the tax rate during the withdrawal years. This is illustrated below:

	Traditional IRA	Roth IRA
Current Balance	**$1,000,000**	**$1,000,000**
Income Taxes @ 40%		**($400,000)**
Net Balance	**$1,000,000**	**$600,000**
Total Growth Rate	**200%**	**200%**
Balance @ Withdrawal	**$3,000,000**	**$1,800,000**
Income Taxes @ 40%	**($1,200,000)**	
Net Balance	**$1,800,000**	**$1,800,000**

Considering the numbers above, the answer from a tax standpoint is simple – if you will be in a lower tax bracket now than you will later when you plan to withdrawal the money, converting money to a Roth IRA might be a wise choice. But what if you are in a high tax bracket now and you are uncertain what your tax rate will look like later when you plan to withdrawal the money? It becomes a riskier

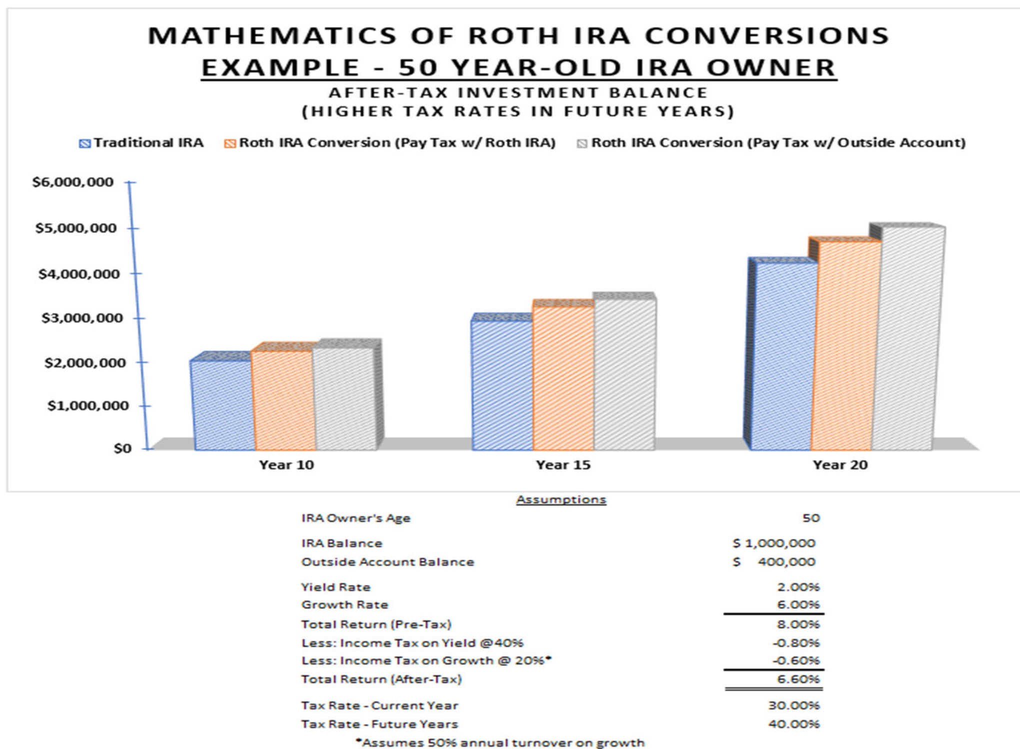
proposition, from at least a tax perspective, because you could be paying more in taxes by converting than if you would have just kept the money in the IRA, letting it grow tax-deferred.

So although the above calculations are a good starting place for the analysis, it is an oversimplified approach. Depending on your specific circumstances and goals, there are other factors and variables that may have an effect on your decision to convert IRA money. We will explore a number of these below:

1. You have a special favorable tax situation in any given year. As we have previously discussed, if you are in a high tax bracket already, in all likelihood, the best decision is to do nothing. But there may be specific years in which you have special favorable tax attributes, i.e., unused charitable contribution carryovers, current year ordinary losses, early retirement, tax credits, net-operating losses, etc., which could drive your income levels into a lower tax bracket. Be on the lookout for these years –it could result in a great opportunity to pay taxes on converted IRA money for that particular year.

2. Your financial plan illustrates you have no need for RMD income when you are retired. The government will force you to take RMDs from an IRA at 70½ whether you like it or not. The same requirement does not exist for Roths. At a basic planning level, if you have no need for this stream of income when you retire, the Roth offers the flexibility of keeping the money in the account to continue to grow tax free, allowing you to access it only when you need it.

3. A separate bucket of money is available to pay the income tax on IRA conversion money. This certainly is a more technical analysis, but as the chart shows below, paying taxes from IRA money to convert IRA money to Roth money is a less effective tax planning strategy than using outside, non-retirement resources to pay the taxes on the conversion. This illustration assumes the same growth rate, but higher future tax rates.



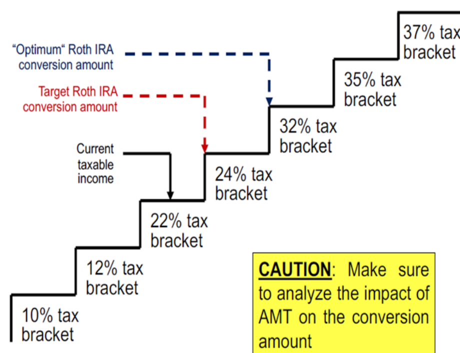
Assumptions

IRA Owner's Age	50
IRA Balance	$ 1,000,000
Outside Account Balance	$ 400,000
Yield Rate	2.00%
Growth Rate	6.00%
Total Return (Pre-Tax)	8.00%
Less: Income Tax on Yield @40%	-0.80%
Less: Income Tax on Growth @ 20%*	-0.60%
Total Return (After-Tax)	6.60%
Tax Rate - Current Year	30.00%
Tax Rate - Future Years	40.00%

*Assumes 50% annual turnover on growth

4. There is a considerable amount of room up to the next marginal tax bracket allowing you to convert and stay in the same tax bracket. This requires some careful tax planning as the below chart details. For example, if you are in a 24% percent tax bracket, it is worth calculating the conversion amount necessary to keep you in the 24% tax bracket – so you do not end up in the 32% bracket due to the additional income. Not only do you save 8% on your converted income – but you save 8% on all other taxable income as well for that particular tax year.

Mathematics of Roth IRA Conversions



5. One of your goals is to allow your heirs to take advantage of post-death income tax free distributions. Because Roth money passes to your heirs tax free, distributions from a Roth account do not result in increased income taxes for them. Your heirs will be subject to RMDs, but these distributions are not taxed. Converting IRA money may be a huge (non-taxable) gift for your heirs, especially if they are in their peak earning years when they receive an inheritance from you. In addition, Congress has proposed legislation titled the **S**etting **E**very **C**ommunity **U**p for **R**etirement **E**nhancement (SECURE) Act. If your adult children are the beneficiaries of your retirement accounts, they may not be able to use their own life expectancies for RMDs any longer. If this legislation passes, it would force adult children beneficiaries to use a 10-year distribution period, resulting in tax deferred money being added to your children's taxable income, and the possibility of a push into higher tax brackets. A surviving spouse is an exception beneficiary under the proposed SECURE Act.

6. You have a taxable estate and wish to reduce the size of your estate through conversion by paying income tax versus estate tax. For larger estates subject to estate tax, converting a traditional IRA to a Roth does not remove the converted asset from your estate. But paying the income tax (likely at a lower tax rate than the estate tax rate) during life on the converted money from other assets does reduce the value of the estate. Federal estate tax rates are currently 40% on any amount above $11.4M for one person and $22.8M for couples utilizing portability.

7. You want to do your surviving spouse a favor by decreasing his or her future tax bill. Single tax rates in the future will likely be higher than marital tax rates today. Your traditional IRA is still taxable to your surviving spouse when they take distributions, whereas a Roth is not. You could pay less in taxes now at a marital income tax rate on converted money than your surviving spouse would pay at single tax rates later upon traditional IRA distributions.

* * *

If you know your tax rate will be higher in the future, converting IRA money to Roth money now might seem the logical choice. But if there is uncertainty concerning both income levels and tax brackets, other factors and objectives may help decide whether conversion is the right answer for you. If you have questions about whether the Roth conversion opportunity is a good solution, let your financial advisor or our financial planning team know and we can assist you with this discussion and analysis.