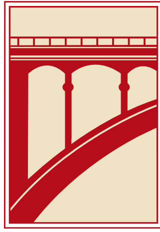

CLIFFORD ASSOCIATES

Investment Counselors since 1915

SECOND QUARTER 2007

WHEN SHOULD YOU NOT CONTRIBUTE TO A TAX-DEFERRED ACCOUNT?

by Bruce White

We all know that we should maximize our contributions to tax-deferred accounts, or should we? Tax-deferred accounts include 401(k)s, IRAs, deferred annuities, 403(b)s, 457s, etc. We know a 30-year old in the highest marginal tax brackets should defer income, and a 70-year old investor in the lower tax brackets probably should not. But if this is true, when does this change, when is the crossover? The answer lies in your assumptions about the future and your personal situation.

TAX-DEFERRED ACCOUNT CHARACTERISTICS

Most often your contribution to tax-deferred accounts is untaxed (pre-tax money). Since the earnings on the investments are deferred until withdrawn, the compounding effect of this larger sum should result in a larger retirement account in the future.

Annuities do not enjoy a tax deduction for contributions, and all

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FIDUCIARY OR SUITABILITY: WHICH SUITS YOU?

by Peter Boyle

At Clifford Associates, we believe the clients of firms offering fee-based investment advice should to be provided a uniform level of investor protection. As a result, we applaud a recent decision by the U.S. Court of Appeals. In that ruling, the court struck down a Securities Exchange Commission (SEC) rule that would have exempted brokers who provide investment advice on fee-based accounts from regulation under the Investment Advisers Act ("Act").

It is our belief that the SEC's primary role is to protect the investor. Instead of providing exemptions, it should be working toward uniform fiduciary standards for *all* advice-givers whether investment adviser or broker-dealer.

Five years ago, the SEC proposed this rule to exempt certain *fee-based* programs of brokers from registration, fiduciary and disclosure requirements of the Investment Advisers Act. Many organizations objected to the proposed rule because its interpretation resulted in two disparate standards of market conduct—one, a *fiduciary* standard for people registered under the Act and a second, lower *suitability* standard for brokers acting as fee-based consultants or advisers.

For those who have not followed these events or do not fully appreciate what might seem like trivial distinctions, some background and review is warranted. While the lines continue to blur between providers of investment services, these providers still differ not only in the type of services offered and how they charge for them, but also in the regulatory requirements and important obligations due their clients. These key distinctions, including whether a provider has a clear obligation to act in each client's best interests or disclose potential conflicts of interest, depend on which legal category the provider falls within under our securities laws.

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IT IS OUR BELIEF THAT THE SEC'S PRIMARY ROLE IS TO PROTECT THE INVESTOR.

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by Ken Dike
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distributions of the increase-over-purchase amount are taxed at ordinary income tax rates. Variable annuities (annuities with sub accounts invested in mutual funds) are cynically described as "turning capital gains into ordinary income," resulting in higher tax rates than necessary.

With non tax-deferred investments (post-tax money) taxes are paid annually on realized capital gains, dividends and interest earned. Withdrawals at retirement are not taxed. Currently realized gains and dividends enjoy a lower tax rate than ordinary and taxable income.

YOUR PERSONAL SITUATION AND FORECASTS:

Any calculation to answer the question of whether to invest in a tax-deferred account requires difficult assumptions about the future.

- **Does your employer contribute?** Often employers contribute an amount into a 401(k)-type retirement account for employees. In almost all cases this answers your question; you should at least contribute the amount required to get the employer's matching contribution. Regardless of age or tax rate, you should not turn down free money.

- **How many years until distribution?** When will you need to take out the deferred money for retirement income? Depending on your personal financial situation and marginal tax rate in retirement, you should probably defer withdrawals as long as possible to maximize the deferred compounding effect. Currently required minimum distribution begins at age 70 1/2, but usually can be taken after age 59 1/2 without penalties. We generally recommend exhausting post-tax dollars prior to pre-tax deferred accounts to support retirement income needs.

  When should you distribute more than your required minimum distribution? There is a required minimum distribution (RMD) in most plans 90 days after the year in which you turn 70 1/2. However, you are in control of the timing of these distributions. If after age 59 1/2 your marginal tax rate is low in a particular year, it is wise to withdraw more than the minimum until your tax rate in that year is maximized.

- **What is your expected investment return?** This may be the most difficult assumption to make. Expected returns are more easily assumed over longer periods of time, but will depend on asset allocation decisions and future market returns for equities and fixed income investments. If your return expectations are high, the value of the deferral of taxes increases, resulting in a bias towards contributing to a tax-deferred investment account.

- **What is your current marginal tax rate?** There are now six different marginal tax rates. Dividends and realized capital gains enjoy lower than maximum rates. An examination of your last tax return or a discussion with your accountant will define your rate. State tax rates differ depending on the state and income level, and must be added to your federal rates.

- **What is your expected future marginal tax rate?** It has always been assumed that an investor at retirement will be in a lower tax bracket than during working years (see accompanying chart for post World War II historical tax rates). This may not be so. As we look at the current marginal tax rates and federal government future

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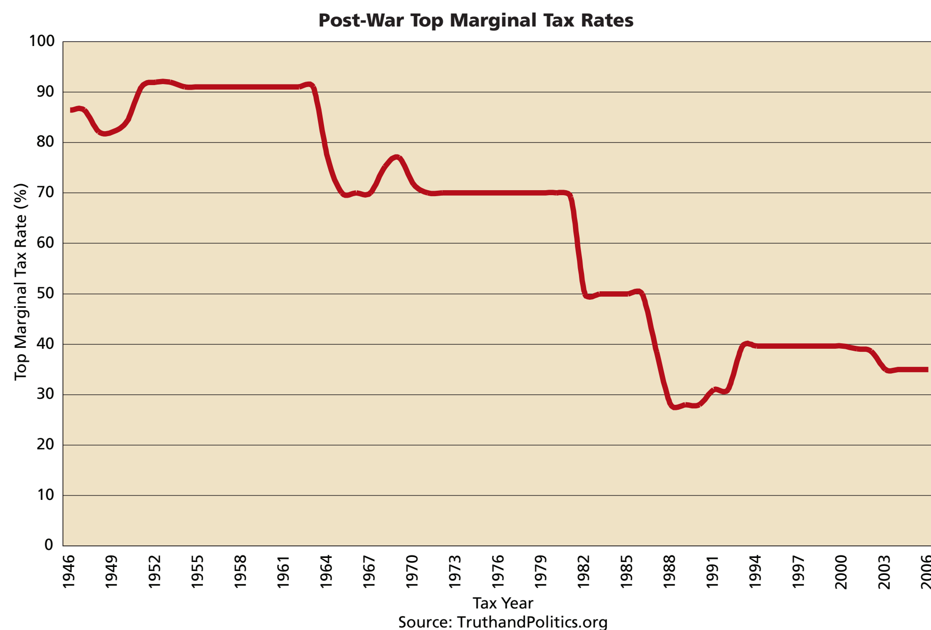

When Should You NOT Contribute continued from page 2

obligations, can we assume that future tax rates will be lower, the same or higher when we retire? In the current political environment, earned income, the alternative minimum tax, capital gains and dividend treatment are all under review for the higher earning taxpayer. If future tax rates increase, we may regret deferring income into a higher marginal tax bracket..

A TAX-FREE ALTERNATIVE

An alternative is to invest current post-tax dollars into municipal bonds which have no tax liability but limit potential growth. Rates are obviously lower and subject to interest rate changes during your savings years. Current rates are about 4% for an insured 10-year California bond.

EXAMPLE #1

Let's say you are in a 35% combined federal and state marginal tax bracket, that you get no matching contribution from your employer (or have already reached the maximum match), and that you deposit $100 into your tax-deferred account. You expect to earn 7% on that deposit, and will withdraw in 20 years, when you estimate your future tax rate at 50%.

- Pre-tax Contribution: $ 100
- Compounded value after 20 years at 7%: $ 387
- After-tax distribution: $ 194

With the same assumptions, below is the calculation of the same $100 invested in an after-tax, non-deferred account. Since we must use an after-tax return each year, let's assume that during the life of the investment your tax rate is 40%, leaving an after-tax return of 4.2%.

- Post-tax Contribution: $ 65
- Compounded value after 20 years at 4.2%: $ 148
- No tax at distribution: $ 148

With these assumptions, you should contribute to a tax-deferred retirement plan.

EXAMPLE #2

Let's say you are in a 35% combined federal and state marginal tax bracket, that you get no matching contribution from your employer (or have already reached the maximum match), and that you deposit $100 into your tax-deferred account. You expect to earn 7% on that deposit, and will withdraw in 10 years, when you estimate your tax rate at 50%.

- Pre-tax Contribution: $ 100
- Compounded value after 10 years at 7%: $ 197
- After-tax distribution: $ 99

With the same assumptions, below is the calculation of the same $100 invested in an after-tax, non-deferred account. Again, let's assume that during the life of the investment your tax rate is 40%, leaving an after-tax return of 4.2%.

- Post-tax Contribution: $ 65
- Compounded value after 10 years at 4.2%: $ 98
- No tax at distribution: $ 98

As you can see with these assumptions, the decision to contribute to a tax-deferred retirement plan over a non-deferred account is less compelling and somewhat muddy. Further discussions regarding the assumptions used, particularly those which are more speculative in nature, will help to determine the path forward.

CONCLUSION

More often than not, this type of analysis leads to the conclusion that you should maximize contributions to your tax-deferred accounts. Whether contributing to a tax-deferred or non-deferred account, it is the discipline of regular contributions that is the real key in achieving your projected outcome. §

THE SECURITIES LAW RECOGNIZES TWO TYPES OF PROVIDERS: INVESTMENT ADVISERS, WHO ARE IN THE BUSINESS OF GIVING ADVICE ABOUT SECURITIES, AND BROKERS, WHO ARE IN THE BUSINESS OF BUYING AND SELLING SECURITIES ON BEHALF OF THEIR CLIENTS.

Fiduciary or Suitability: Which Suits You? continued from page 2

The securities law recognizes two types of providers: investment advisers, who are in the business of giving advice about securities, and brokers, who are in the business of buying and selling securities on behalf of their clients.

INVESTMENT ADVISERS

Investment Advisers (such as Clifford Associates) are subject to a *fiduciary duty*. This means they have to put your interests ahead of theirs at all times by providing advice and recommending investments that they view as being in your best interest. Investment advisers are also required to provide up-front disclosures about their qualifications, what services they provide, how they are compensated, possible conflicts of interest, and whether they have any record of disciplinary actions against them.

BROKERS

Brokers, by contrast, are generally not considered to have the same fiduciary duty to their clients, although this

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TWO DIFFERENT INVESTMENTS COULD BE EQUALLY SUITABLE FOR A GIVEN CLIENT, BUT ONE MIGHT COMPENSATE THE FINANCIAL PROFESSIONAL TO A GREATER EXTENT.

Fiduciary or Suitability: Which Suits You?
continued from page 3

standard may apply in certain circumstances. Instead, brokers are required to: 1) know their clients' financial situations well enough to understand their financial needs, and 2) recommend investments that are *suitable* for them based on that knowledge. Brokers are not required to provide up-front disclosures of the type provided by investment advisers, including, but not limited to their conflicts of interest.

A couple of simple illustrations can highlight the differences in standards: 1) Two different investments could be equally suitable for a given client, but one might compensate the financial professional to a greater extent. Investment advisers require such a disclosure while broker rules would not. 2) A bond can be sold to a client from a brokerage firm's inventory (principal trade) to profit the firm, with little required disclosure. This activity is essentially prohibited for investment advisers without complete disclosure.

FINANCIAL PLANNERS

Financial planners are not separately regulated and, in fact, have no legal definition. Instead, they could be considered a hybrid. Their regulation and the level of responsibility they owe clients depend on the type of services they provide. Planners who provide investment advice must be registered or licensed as investment advisers and are subject to a fiduciary duty. Those who trade securities must be registered or licensed representatives of brokers. Some financial planners perform other activities that do not involve securities and therefore are not regulated under laws governing either investment advisers or brokers.

These legal requirements are further complicated by the fact that different standards can apply when investment providers serve as both investment advisers and brokers. For example, investment advisers who also buy and sell securities for customers must meet the requirements applicable to both investment advisers and brokers. The same is not true of brokers. Brokers are permitted to offer investment advice in connection with their brokerage services without being regulated as investment advisers. As a result, the advice they offer is subject to the suitability standard that governs brokerage activities rather than the higher fiduciary duty that applies to investment advisers.

It is important to note that missing from this discussion are banks. With the exception of mutual funds managed by banks, banks are specifically excluded from regulation under the Investment Adviser's Act, further adding to investor confusion on the subject.

Considering the recent investment scandals, much could be done to provide uniform regulation and disclosure requirements. While not without flaws, the Act and standards of practice espoused by the investment adviser industry and its member associations should to continue to lead this discussion. The Court of Appeals decision, we believe, is a great step in the right direction.

The Investment Adviser Association, of which we are a charter member, has published a client service pamphlet from which much of this information was derived. If you or someone you know would like further information on this topic, please let us know. §

CONSIDERING THE RECENT INVESTMENT SCANDALS, MUCH COULD BE DONE TO PROVIDE UNIFORM REGULATION AND DISCLOSURE REQUIREMENTS.