

Improving Your Finances

Tips for Tax Time

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Welcome to the inaugural issue of *Improving Your Finances*, a free publication available to former subscribers to *Morningstar PracticalFinance*. Much like *PracticalFinance*, each installment of *Improving Your Finances* will have a specific theme. And with April 15 bearing down on us, this issue is all about taxes.

Investors of all income levels will be able to convert their traditional IRAs to Roths beginning this year. Being able to take some of your retirement income on a tax-free basis is tantalizing, but the downside is that you'll have to take a tax hit when you convert to a Roth. To help you determine whether a conversion is worthwhile, I condensed the most important points into an easily digestible article with a Q&A-style format. My IRA Conversion Fact Sheet appears on Page 3. And to steer you toward the best investments to put inside an IRA, I've included an excerpt from my recently published book, *30-Minute Money Solutions*. "Find the Best Investments for Your IRA" begins on Page 6.

Elsewhere in this issue, I discuss a tax-related concept that hasn't gotten enough attention in the financial media: asset location. In a nutshell, successful asset location means placing some types of investments in taxable accounts and others in tax-sheltered vehicles, all with an eye toward reducing the drag of taxes and improving long-run return. "What Goes Where? The Art of Asset Location" begins on Page 13. And because there are situations when practical considerations will trump taxes, "When Should You Save in a Taxable Account?" discusses some of the key issues to consider when deciding to hold assets outside of an IRA, company retirement plan, or other tax-sheltered vehicle.

Finally, the issue includes an overview of some of the tax-related changes that go into effect for 2010. Due to currently subdued inflation, many of the key numbers are staying the same—including IRA and 401(k) contribution limits. But there are a few changes to the tax code that are worth keeping tabs on, including required minimum distributions (required again!) and a continuation of the homebuyer credits that went into effect last year. I've summarized the key tax-law changes in an article that begins on Page 9, and I've included another article, "What Changes to the Estate Tax Mean for You" on page 18. While tax advisors had been joking that 2010 was shaping up as "a great year to die" because of the estate-tax repeal, the reality of the estate-planning landscape is far more complicated. My article discusses what we do know about the current estate-tax system, and how the rules could change.

As always, I appreciate your feedback on the newsletter. Please feel free to drop me a line at Christine.benz@morningstar.com.

IRA Conversion Fact Sheet

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Investors of all income levels are now able to convert their traditional IRA assets to Roth IRAs as of the beginning this year. The opportunity to take tax-free withdrawals on IRA investments certainly holds appeal, but a conversion isn't for everyone. Check with a tax specialist to ensure that you've considered the ramifications—including the potential tax liability—before converting.

Here are some common questions related to IRA conversions, along with the answers.

What's changing in 2010?

Two things. First, income limits on conversions have been lifted, so now anyone can convert from a traditional IRA to a Roth. Second, those who convert in 2010 will be able to spread the taxes associated with the conversion over two years—2011 and 2012.

Is the change permanent or only for 2010?

Income limits are permanently lifted beginning in 2010. However, the special tax treatment (splitting the tax hit over 2011 and 2012) is available only for conversions made in 2010.

What are the benefits of converting?

There are two key benefits. First, Roths offer tax-free withdrawals in retirement, whereas withdrawals from traditional IRAs are taxed as ordinary income. Second, Roths don't require you to take distributions during retirement, so if you don't need the money you can let the assets accumulate for your heirs.

Who is a good candidate for conversion?

In general, younger people are better candidates for conversion than are older investors who are close to retirement or already retired. Those who have the cash on hand to pay the taxes associated with the conversion are also much better candidates for conversion than those who will need to tap the IRA assets to pay the tax. Investors who have a lot of assets in traditional 401(k)s and IRAs may also benefit from a conversion because it will diversify the tax treatment of their in-retirement withdrawals. This article details who might be a prime candidate for conversion and Morningstar's IRA Calculator can help you crunch some numbers.

Who should think twice about converting?

A conversion will tend to be less attractive for older investors who are well into retirement; they won't

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have the chance to recoup the tax hit. Conversions are also usually a bad idea if tapping the IRA assets is the only way to pay conversion-related taxes. Finally, conversions won't generally make sense for those who haven't saved much for retirement and will therefore be in a lower tax bracket in retirement than they are now. This article discusses who should think twice about converting.

Are the income limits for starting a Roth from scratch going away in 2010, or is conversion the path for investors whose income is over the limit?

The income limits to open a Roth IRA are still in place; individuals with incomes of more than \$120,000 who can also contribute to a company retirement plan can't open a Roth; the threshold goes up to \$177,000 for married couples filing jointly. However, individuals whose incomes are over those limits can take a backdoor way into a Roth, opening a traditional nondeductible IRA, then converting soon thereafter. They'd owe taxes on any investment earnings at the time of the conversion. This strategy doesn't make sense, however, for those with substantial traditional deductible IRA assets because the taxes associated with the conversion will be based on the breakdown between deductible and nondeductible contributions in the IRA. Check with a tax advisor before opening a "backdoor IRA" because some advisors are concerned that Congress could close this loophole.

Can I roll over a regular 401(k) into a Roth IRA directly?

Yes, assuming you no longer work for the company where you amassed the 401(k). In this case, the rollover functions almost exactly like a conversion; you'll owe taxes on your deductible contributions and investment earnings at the time you convert.

Will I owe taxes because of the conversion?

It depends. If you've made only nondeductible contributions and you don't have any investment earnings in the account, you won't owe taxes upon conversion. If, however, your IRA consists of deductible contributions, rollover assets from a traditional 401(k), and investment earnings—or some combination thereof—you'll owe taxes when you convert.

Should I worry about what the conversion will do to my reportable income (namely, pushing me into a higher tax bracket)?

Yes, and that's one of many reasons to check with a tax advisor before embarking on a conversion. The risk is that in bumping up your income level, you could disqualify yourself for tax credits and deductions that would otherwise be available.

When will the taxes be due?

Normally when an investor converts an IRA, any investment earnings and deductible contributions in the traditional IRA are taxed as income in the year in which the individual converts. For individuals who convert in 2010, however, they can either take the tax hit for the 2010 tax year or split the tax burden across the 2011 and 2012 tax years.

Is there a limit to how much I can convert?

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No. But once you're looking at converting large sums, it's especially important to consider the tax implications, both the effect on your tax bracket and whether you have money on hand to pay the conversion-related taxes.

Is the conversion permanent (or can I convert back)?

You can convert back through what's called a recharacterization. A recharacterization enables you to change the character of a Roth IRA to a traditional IRA, and vice versa. This can be an important lever if you convert your IRA and it turns out that the tax burden associated with the conversion is far greater than you had calculated, or if the conversion pushes you into a higher tax bracket and reduces your eligibility for tax credits and deductions. You'll also need to do a recharacterization if you convert your IRA but then determine that you weren't eligible to because of income limits. This article lays out some of the details.

Will I be able to tap principal in the new Roth IRA without penalty?

Yes, assuming five years have elapsed since you made the conversion.

Do I have to convert all of my accounts, or is a partial conversion possible?

A partial conversion is possible and advisable if converting in a single year creates an extreme tax burden or pushes you into a higher tax bracket. This article details the ins and outs of partial conversions.

If I do a partial conversion, can I convert only nondeductible traditional IRA contributions?

That would be nice, wouldn't it? Regardless of which IRA assets you convert, the assets will all receive the same tax treatment upon conversion, based on the proportion of nondeductible contributions and deductible contributions/investment earnings. This article provides a concrete example of how this works.

After I convert, can I contribute to the new Roth account this year or in the future?

Yes, but only if your income is under the limits for new contributions (\$120,000 for individuals who can contribute to a company retirement plan and \$177,000 for married couples filing jointly). If your income is above these levels, you'll need to open a traditional, nondeductible IRA and then convert it.

Find the Best Investments for Your IRA

“The Lord works in mysterious ways.”

Uh-oh, I thought, as I read the first line of a letter from a Morningstar reader, who proceeded to regale me with an investment-related tale worthy of an O. Henry story.

A 50-something computer programmer, he was devastated when he lost his job in the financial-services industry back in mid-2008. With a mortgage and two kids hurtling toward college, the layoff obviously brought worries about what the future would bring. At the time of his layoff, he was also panicked about his 401(k) portfolio, which included a healthy dose of stock funds as well as many shares of his employer’s stock, which was quickly going from bad to worse.

Here’s where the plot twist comes in: Shortly after the layoff, he had rolled over his 401(k)—the bulk of his retirement savings—into an IRA. Paralyzed by indecision over where to invest the money, he had left the assets sitting in an ultra-low-yielding, but ultra-safe money market fund. In so doing, his retirement portfolio was cushioned during the late 2008-early 2009 market sell-off, the worst since the Great Depression, which saw the S&P 500 dropping by 50%. Even more fortuitously, he had also dumped his company stock at an opportune time. Soon after he sold the stock and rolled his money into the IRA, shares of his former company skidded from \$25 a share down to about \$3. He hadn’t yet found a new job at the time he wrote to me, but he noted that his inaction toward his retirement portfolio had saved him far more money than he had lost in income from his job.

Yet, he didn’t want to look a gift horse in the mouth. He knew how lucky he had been in sidestepping the market’s troubles, but he also knew that his conservative portfolio could be left in the dust if the market rebounded. And indeed, when he wrote me in the spring of 2009, the major stock indexes were scoring huge gains each day. He wanted guidance, posthaste, on getting his portfolio invested for good.

It’s easy to see why this programmer, as well as a lot of other would-be IRA investors, suffer from “analysis paralysis.” Once you decide whether to invest in a traditional or Roth IRA, you then have to sort among an overwhelming array of options. You can put almost anything inside an IRA wrapper: individual stocks and bonds, money market funds, CDs, or mutual funds. Life insurance policies and investments made on margin—that is, those funded with borrowed money—are among the few mainstream investment types that can’t go inside an IRA.

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However, because IRAs offer either tax-free (Roth IRA) or tax-deferred (traditional IRA) compounding, it's usually a mistake to put any sort of investment that itself has tax benefits inside an IRA wrapper. Municipal bonds are a great example: You don't typically pay federal taxes on the income from municipal bonds or bond funds, but in exchange you usually have to accept a lower level of income than you'd have from a taxable bond or bond fund. For that reason, you're better off holding tax-advantaged investments like municipal bonds and variable annuities (to the extent that you own them) in your taxable accounts, and only after you've funded your IRA and company retirement plan.

To identify the best investments for your IRA, you'll need:

* Statements for all of your retirement holdings: 401(k)s, 457s, 403(b)s, and other IRAs

* Morningstar's Instant X-Ray tool

* **Start the Clock**

Step 1.

The first step in selecting investments for your IRA is to think about what role your IRA will play in your retirement portfolio. Will it take up a big share—either because you're just starting out and plan to make many more IRA investments in the future or because you've rolled over a large sum of money from your company retirement plan? If so, move on to Step 2.

If you consider your IRA to be more of a supporting player because the bulk of your retirement assets are elsewhere, either in your company retirement plan or your taxable account, go to Step 3.

Step 2.

If you have a large sum of money stashed in an IRA—or expect that your IRA will grow to be a large share of your overall retirement portfolio in the future—you'll want your IRA to be well-diversified and populated with “core” investment types like large-cap stock mutual funds and high-quality bond funds.

If you have other assets earmarked for retirement, in addition to the money that you're putting into an IRA, be sure to take those holdings into account when deciding what to put in your IRA. Morningstar's Instant X-Ray tool can help you size up your existing portfolio's stock/bond/cash composition and also shows you how well it's diversified across various investment styles. (The Morningstar Style Box provides a visual depiction of a portfolio's investment-style mix.) Simply enter the tickers for each of your holdings into the X-Ray tool, then click Show Instant X-Ray.

Compare the current allocations of your existing retirement portfolio with your asset-allocation targets. Once you've determined where you need to add, you can select the specific investments. If you're looking for core-type investments to populate your company retirement plan, Morningstar's Fund Analyst Picks in the large-cap equity (both international and U.S.), intermediate-term bond, world-stock, world-allocation, and conservative- and moderate-allocation categories can provide a good starting point. Some of my favorites are Dodge & Cox Stock DODGX, Sequoia SEQUX, and T. Rowe Price Personal Strategy Income PRSIX.

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Step 3.

Are you opening an IRA to augment retirement monies that you hold elsewhere? If so, you, too, can hold core-type investments in your IRA.

But you can also use the IRA to fill holes in your company retirement plan. For example, say your plan includes adequate stock funds but its bond funds charge more than 1% per year in annual expenses—a princely sum that’s sure to take a big cut of your long-term return. If that’s the case, you can fill up your company retirement plan with the decent stock funds and leave the bond portion of your portfolio to an IRA. Again, Morningstar’s Instant X-Ray tool can help you see where you’ve got holes in your existing asset mix.

And because the world is your oyster when funding an IRA, you can also include investment types not commonly found in company retirement plans, including funds dedicated to real estate investments, commodities, or Treasury Inflation-Protected Securities. All of these investment types do a good job of diversifying a portfolio that’s composed primarily of stocks and bonds. They also can be a headache when held outside of a tax-sheltered account, because they generate a lot of taxable income, so they’re ideal holdings for an IRA.

Morningstar’s Fund Analyst Picks within those categories are good starting points if you’re using your IRA to support core-type funds you hold elsewhere. Some of my favorite “supporting player” IRA ideas are Royce Special Equity RYSEX, Third Avenue International Value TAVIX, and Vanguard Inflation-Protected Securities VIPSX.

Next Steps

- ▶ To the extent that you hold bonds in your portfolio, it generally makes sense to hold them within tax-protected accounts like your IRA or company retirement plan. That’s because bonds tend to generate a lot of income, which is taxed at rates as high as 35%. Stocks, meanwhile, typically crank out less income. Also, the tax rate on capital gains and stock dividends is currently much lower than is the case for bond income, though that treatment is set to expire at the end of 2010.
- ▶ I tend not to be a big fan of mutual funds with high turnover rates, meaning that the manager makes frequent changes to his or her investment portfolio. However, to the extent that you’re attracted to such a fund type, it makes sense to shelter it within the confines of an IRA, where you won’t owe taxes on your holdings from year to year. That’s because high-turnover funds often generate short-term capital gains, which are taxed at your relatively high ordinary income tax rate. (Long-term capital gains receive much more favorable tax treatment.)

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Stay a Step Ahead of the Tax Collector

A good mantra, for investing and the rest of your life, is “Focus on what you can control.” While most people are inclined to put taxes into the “out of my control” bucket, that doesn’t have to be the case. (For proof, look no further than the army of tax advisors and attorneys geared toward helping the well-heeled shave their tax bills.) Key to cutting your tax bill is staying current on tax-law changes. Although there aren’t yet details on tax hikes likely to go into effect because of the federal stimulus plan, here’s a summary of recent and impending tax-law changes. I’ll also give you my thoughts on how you can act to either take advantage of these changes or minimize their effect on your bottom line. Some changes have an impact only on those in very high tax brackets, while others affect people of all income levels.

IRA Conversions

Starting this year, anyone will be able to convert an IRA, regardless of income limit. And those who convert in 2010 will be able to spread the conversion-related taxes over two years: 2011 and 2012. This article details the ins and outs of IRA conversions, as well as prime candidates for conversion.

Required Minimum Distributions

Those over 70 1/2 years old are again required to take minimum distributions from their traditional IRAs, 401(k)s, and some other retirement plans, after distributions were suspended for 2009 to allow retiree account balances to rebound. This article details the ins and outs of required minimum distributions, and IRS Publication 590 includes tables to help you calculate the appropriate distribution for you. Because the penalties for not taking distributions are onerous (a 50% tax on the amount you should have taken out but didn’t), ask your mutual fund company or brokerage firm to sign you up for automatic distributions.

Dividend Tax

Through 2010, the dividend-tax rate remains at zero for taxpayers in the 10% and 15% tax brackets, and is 15% for all other taxpayers.

Long-Term Capital Gains Tax

Through 2010, taxpayers in the 10% and 15% brackets will not owe capital gains tax on the sale of assets they’ve owned for a year or more. Long-term capital gains tax rates remain at 15% for all other taxpayers.

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Estate Tax

The federal estate tax is repealed on a temporary basis in 2010 and then is set to jump up to 55% for estates of more than \$1 million in 2011. However, the estate-tax landscape remains murky. Some tax pundits expect Congress to put in place a new estate tax soon, which could be retroactive to January. Given that the estate-tax system is bound to be in flux during the next few years, it pays to check with an estate-planning attorney to make sure your plan still makes sense.

Gift Tax

The annual gift-tax exclusion stays the same as it was in 2009: \$13,000. That means you can gift \$13,000 apiece to an unlimited number of people this year without having to worry about a gift tax or even fill out the gift-tax paperwork.

Say, for example, you and your spouse would like to help your daughter and her husband buy a new house. You could each gift \$13,000 to both your daughter and son-in-law, for a total of \$52,000. Savers in 529 college-savings plans can actually gift \$65,000 in a single year without triggering a gift tax, assuming they make no further contributions to the same individual's college plan in the subsequent four years. In that case, the IRS assumes that your contribution is spread over five years ($\$13,000 \times 5 = \$65,000$). Couples can actually contribute \$130,000 to one child's college-savings plan in 2009, assuming they make no further gifts from 2010 through 2013, without getting into gift-tax terrain.

Also, if you're gifting to pay educational or medical expenses, you can circumvent the gift-tax system altogether by making payments directly to the educational or medical institution.

401(k) Contribution Limits

The maximum 401(k) contribution remains the same for 2010: \$16,500 for those under age 50 and \$22,000 for savers over 50. (Contribution limits for 403(b) and 457 plan participants are the same.) Note that the 401(k) limits apply to both Roth and traditional 401(k) contributions. However, because you're contributing aftertax dollars to the Roth 401(k), your effective contribution rate is much higher than it is for the traditional 401(k). This is one of several reasons I think the Roth 401(k) can be a very attractive option for higher-income savers looking to max out their tax-advantaged options.

IRA Contribution Limits

IRA contribution limits are also unchanged from 2009: \$5,000 if you're under 50 and \$6,000 for individuals over 50. These amounts apply whether you're contributing to a Roth IRA, a traditional deductible IRA, or a traditional nondeductible IRA.

The 2010 income ranges for Roth eligibility are also the same as in 2009. Individuals filing singly and making less than \$120,000 who are covered by a company retirement plan will be able to make at least a partial Roth IRA contribution in 2010. (The amount you can contribute is "phased out," or reduced, for single filers who make between \$105,000 and \$120,000 a year.) Married couples filing jointly can make at least a partial contribution if they are covered by a company plan and earn less than \$177,000 per

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year in 2010. (Contributions begin to phase out for joint filers earning between \$167,000 and \$177,000.) Individuals of any age can make a Roth IRA contribution, as long as they have “eligible compensation,” such as wages, salaries, tips, and commissions.

Individuals earning less than \$66,000 in 2010 who are covered by a company retirement plan can make at least a partially deductible contribution to a traditional IRA. (Contributions phase out, or are reduced, for individuals who make between \$56,000 and \$66,000.) Married couples filing jointly can make at least a partially deductible IRA contribution if they earn less than \$109,000. (Contributions begin to phase out for couples who make between \$89,000 and \$109,000.)

However, despite the deductibility of traditional IRA contributions for some individuals, I think the Roth is the better bet for most people. That’s because you’ll enjoy tax-free withdrawals from a Roth IRA, whereas you’ll owe ordinary income taxes on the traditional deductible IRA withdrawals. Also, the fact that Roth IRAs don’t require mandatory withdrawals is an added benefit for individuals who don’t need the money in retirement; that allows Roth investors to stretch out the tax-saving effects for a longer period of time than is possible for a traditional IRA.

In addition, you can still contribute to a Roth at any age, as long as you have eligible compensation, but traditional IRA contributions aren’t permitted after age 70 1/2. Finally, should you need the money before retirement, a Roth enables you to put your mitts on your contributions at any time without taxes or penalty. Tapping your retirement accounts early isn’t a great idea, but this is by far the best option if you’re in a bind.

First-Time Home Buyer Tax Credit

The First-Time Home Buyer Tax Credit, originally set to expire last year, has been extended through the first part of the year. People who buy a principal residence between Jan. 1, 2009, and April 30, 2010, may be able to claim a tax credit that amounts to 10% of their purchase price, with an upper limit of \$8,000. Should the taxpayer sell the home within three years or no longer use it as a principal residence, he or she will have to return the credit.

To claim the credit, buyers must not have owned a principal residence within the past three years. There are also income limitations to claiming the credit. For purchases made after Nov. 6, 2009, the credit begins phasing out for single filers who earn more than \$125,000, and married couples filing jointly can’t claim any portion of the credit if they earn more than \$225,000. (Purchases made between Jan. 1, 2009, and Nov. 6, 2009, were eligible for the credit, but buyers were subject to more stringent income limitations.)

Move-Up/Repeat Home Buyer Tax Credit

Existing homeowners who purchase a principal residence between Nov. 6, 2009, and April 30, 2010, are eligible to claim a credit equal to 10% of the new home’s purchase price, up to a limit of \$6,500. If the newly purchased home costs more than \$800,000, the homebuyers are not eligible for the credit. As

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with the first-time home buyer tax credit, this credit begins phasing out for single income-tax filers who earn more than \$125,000 and married couples filing jointly who earn more than \$225,000.

Credit for Home Energy-Efficiency Improvements

Homeowners can receive a tax credit for 30% of the cost of certain efficiency-improving items, up to \$1,500, for improvements made during the 2009 and 2010 tax year. The credit was previously only for 10% of eligible costs. Items such as energy-efficient windows, heating and cooling units, and insulation qualify. [Click here for more details.](#)

Sales Tax

Those who itemize their deductions can no longer deduct their state sales tax paid rather than deducting their state and local income taxes.

What Goes Where? The Art of Asset Location

I'll confess: When it comes to matters of money and investing, there are a handful of topics that make my head hurt. One of them is "asset location"—essentially, the placement of investments in taxable or tax-sheltered accounts.

Why is asset location such a sticky wicket? For one thing, the tax treatment of investments changes frequently, so what may be an optimal asset placement today may not be a few years from now. Dividends provide a great case in point. Prior to 2003, income from stock dividends was taxed at the ordinary income tax rate, so you'd generally want to hold income-rich stocks in your tax-sheltered accounts.

But when dividends began to be taxed at the lower, capital-gains tax rate, they were no longer verboten for taxable accounts. As the currently low dividend-tax rates are set to expire at the end of this year, dividend-tax treatment is again up for grabs, so I'd be hard-pressed to recommend that you hold dividend payers in your taxable accounts until there's some clarity on the issue.

In addition to tax treatment confusion, practical considerations sometimes completely contradict advice that makes good tax sense. Most of us naturally use our retirement accounts (401(k)s and other company-retirement plans and IRAs) as a storehouse for our longest-term savings, so it's only logical that we'd be inclined to invest in long-term assets (namely, stocks) there.

Meanwhile, from a practical standpoint it's logical to want to hold more safe, stable, and liquid assets (namely, bonds and cash) in accounts that we can readily tap without strictures or penalties—our taxable accounts. Yet as much logical sense as those asset-placement arrangements might seem to make, they precisely contradict what a tax advisor would tell you to do. Because income from bonds and cash is taxed at your ordinary income tax rate, that's a powerful argument for holding bonds in your tax-sheltered accounts while keeping at least some stocks in your taxable account.

So how should you navigate this confusing landscape? There are no one-size-fits-all solutions, and it's worth revisiting your asset-location framework every few years, to make sure your plan syncs up with the current tax rules. But here are some general guidelines.

Hold in Your Tax-Sheltered Accounts: High-Returning Assets with High Tax Costs

Because you don't have to pay taxes from year to year on income or capital gains you earn in tax-sheltered accounts like IRAs and 401(k)s, these are good receptacles for higher-returning investments

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that also have heavy tax consequences. The best example would be junk bonds, junk-bond funds, and multisector-bond funds, all of which kick off a high percentage of taxable income. And while it's a stretch to call high-quality bonds and bond funds "high-returning" right now, they're also a better fit for tax-sheltered accounts than for taxable because their payouts are taxed at an investor's ordinary income tax rate.

So generally speaking, to the extent that you hold bonds, you're better off doing so within the confines of a tax-sheltered account. If you need to hold bonds in your taxable accounts, use the tax-equivalent yield function of Morningstar's Bond Calculator to determine whether a municipal bond or bond fund might offer you a better aftertax yield than a taxable bond investment. (Income from munis is free of federal and, in some cases, state income taxes.)

By contrast, stocks and stock funds are generally a better bet for taxable accounts, for reasons I'll detail in a minute. That said, not all stocks belong in the taxable bin. Although they enjoy relatively low tax treatment currently, dividend-paying stocks are arguably a better fit for taxable rather than tax-sheltered accounts.

As I noted earlier, the tax treatment of dividend income is set to expire after this year; unless Congress takes action, dividends will again be taxed as ordinary income beginning in 2011. Also, dividend income, like bond income, isn't discretionary. Whereas stock investors can delay the receipt of capital gains simply by hanging on to the stock, investors in dividend-paying stocks don't have that kind of control. That makes dividend payers, regardless of tax treatment, less attractive than nondividend payers from a tax standpoint.

Your tax-sheltered accounts are also the right spot for REITs, whose payouts are generally considered nonqualified and taxed at ordinary income tax rates. Preferred stock, too, is on the bubble, depending on the type of preferred you're dealing with, and therefore is apt to be a better fit within the confines of a tax-sheltered account. Traditional preferreds generally qualify for dividend-tax treatment, whereas income from trust preferreds is taxed at an investor's ordinary income tax rate. Dividends from some foreign stocks and funds may also be classed as nonqualified, meaning they will be taxed as income.

Finally, to the extent that you hold mutual funds that churn through their portfolios frequently, you're better off doing so within your company-retirement plan or IRA. Such funds tend to generate a lot of short-term capital gains, which are also taxed as ordinary income.

Hold in Your Taxable Accounts: Higher-Returning Assets With Low Tax Costs

The above exceptions notwithstanding, there are compelling reasons to hold stocks in your taxable rather than tax-sheltered accounts.

As I noted earlier, long-term capital gains, which is what you have when you sell a stock that you've held for at least a year, are taxed at a much lower rate than is bond income—currently 0% for inves-

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tors in the 10% and 15% tax brackets, and 15% for investors in the 25% tax bracket and above. (Those favorable tax rates, like dividend tax rates, are set to expire at the end of 2010. But if they do, they'll revert back to the rates in place before 2003—20% for most investors.)

Another key reason to hold stock in your taxable accounts is that stock investors can also exert a higher level of control over the receipt of capital gains than bond investors—for example, by buying and holding individual stocks or by investing in exchange-traded funds, which have a built-in mechanism for limiting taxable capital-gains payouts. Tax-managed funds and traditional broad market stock-index funds also tend to do a good job of keeping the lid on distributing capital gains.

Hold in Either Account Type: Lower-Returning Assets with High Tax Costs

So the key rules of thumb are that stocks go in taxable accounts and bonds go in tax-sheltered wrappers. But what about lowly old cash? From a pure tax standpoint, holding the assets in a tax-sheltered account makes the most sense, as income from cash investments is taxable as ordinary income, just like bond income.

Here's a case, however, where practical considerations may override the tax argument. One of the key benefits of cash is easy access to your money when you need it, so it simply doesn't make sense to store cash for near-term income needs in tax-sheltered accounts, where you may face taxes and other penalties to pull it out prematurely. And because you're receiving a minuscule income stream from most cash investments these days (you may be holding them for stability as much as real income), the tax hit associated with holding cash in a taxable account is apt to be quite low for most investors.

The bottom line is that if you're holding cash for near-term income needs or as an emergency fund, it makes sense to hold it in a taxable account. If you're holding a sleeve of cash as a component of your retirement portfolio's long-term strategic asset-allocation plan, it's fine to hold it within the context of your tax-sheltered account.

When Should You Save in a Taxable Account?

The tax code is almost always in a state of flux, but the current environment seems particularly up for grabs. Several of the Bush-era tax breaks, including currently low dividend tax rates, were extended through this year but are set to expire thereafter. The estate-tax picture is also murky. Although there is no estate tax in 2010, some tax-watchers think Congress could reinstate the estate tax and give the IRS the discretion to “claw back” taxes that should’ve been paid but weren’t.

Given all the uncertainty, it’s tempting to put asset location—the process of putting tax-efficient investments in taxable accounts while saving less tax-friendly investments for tax-sheltered accounts—into the “Why bother?” column. But that would be a mistake. Although the specifics may change, the broad-brush concepts behind asset location—for example, maxing out your tax-sheltered accounts and stashing tax-inefficient investments inside them—will still hold up. My earlier article discussed some things to think about when managing your portfolio for tax efficiency. Yet as meaningful as those tax savings can be, there are also situations when saving in your taxable account is the right way to go, because practical considerations outweigh the tax hit you’ll take to do so. Here are some of the key occasions when saving within the confines of a taxable account makes sense, even though it could cost you a bit more in taxes from year to year.

You May Need the Money Soon

If there’s a realistic chance you’ll need part of your savings in the near future—for example, you’re saving for a goal that’s close at hand or you’re building an emergency fund—you’re usually better off saving in a taxable account than you are within the confines of a tax-sheltered vehicle such as an IRA, a 401(k), or a college-savings vehicle such as a 529. The key reason is that if it turns out you need to tap the tax-sheltered assets prior to college or retirement, you’ll have to pay penalties and/or taxes to get your mitts on those assets.

Taxable accounts carry no such strictures, though you’ll have to pay taxes on those assets on an annual basis. It’s also worth noting that the tax costs, in absolute terms, of holding short-term assets in your taxable accounts are apt to be quite low right now—one small silver lining of the current, low-yield environment. (Sadly, the tax costs in relative terms—as a percentage of your return—are still very high.)

You’re Multitasking

Sure, in an ideal world you’d save for each of your specific financial goals in exactly the right bucket—

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retirement savings in your company retirement plan and IRA, college savings in a Coverdell and 529, and near-term goals in your taxable accounts.

Here in the real world, though, it can hard to know which of those goals should take precedence. Maybe your child will get a scholarship, thereby obviating the need for her college fund. (Wouldn't that be nice?) Or perhaps you'll need to buy a new roof with the money you had earmarked for retirement. If you have competing financial priorities—or even competing financial “maybes”—you might be better off saving within a taxable account rather than tying the money up in a retirement- or college-specific investment.

If you're multitasking with your investments, however, first check to see whether you're eligible to contribute to a Roth IRA before assuming that a taxable account is the best, most flexible receptacle for your savings. (Single-income tax filers earning less than \$120,000 and married couples filing jointly who earn less than \$177,000 can make at least a partial contribution to a Roth.) The Roth is geared toward retirement, but you can withdraw your contributions at any time for any reason without taxes or penalties. If you don't end up needing the money prior to retirement, you'll be able to enjoy tax-free withdrawals after age 59 1/2. That makes it a good first stop—even before cash—for multitaskers.

You've Maxed Out Your Tax-Sheltered Options

One of the key reasons for saving in a taxable account is purely logistical. If you're a higher-income earner who's in a position to sock a lot away for retirement, you're apt to find that your tax-sheltered options will only take you so far. Investors in 401(k) plans are limited to \$16,500 in annual contributions if they're under 50 and \$22,000 if they're over 50. IRA investors can contribute \$5,000 a year if they're under 50 and \$6,000 if they're over 50. (College savers aren't likely to hit this roadblock: 529 contribution limits, while varying by state, are extremely generous.) If you find yourself in the position of having maxed out all of the tax-sheltered retirement vehicles available to you, saving additional assets in a taxable account will be a necessity. The good news is that if your retirement is many years away, your retirement savings are likely to be skewed toward stocks, which carry lower tax costs than bonds.

Now What?

While taxable investors will forgo some of the tax breaks associated with tax-sheltered investments, it's still possible to minimize the tax hit. For higher-income investors saving for short- and intermediate-term goals, municipal bonds and bond funds can make a compelling alternative to taxable bonds; use the tax-equivalent yield function of Morningstar's Bond Calculator to compare yields on taxable and muni bonds. Longer-term taxable investors have even more options, as stocks tend to be much more tax-friendly than bonds.

What Changes in the Estate Tax Mean for You

Even in normal times, estate planning is a complicated topic. And these are not normal times.

When the Economic Growth and Tax Relief Reconciliation Act of 2001 eliminated the federal estate tax for 2010, there were jokes that this would be a good year for wealthy folks to die.

Now that we're here, however, the repeal of the estate tax doesn't appear to be all that it was cracked up to be. For one thing, it's far from certain that the estate tax will, in fact, be repealed for 2010. Many tax pundits think Congress will take action to reinstate it within the next few months, and if that happens, the new estate tax policy could be retroactive to Jan. 1 of this year. Moreover, even if estate-tax repeal stands for 2010, that doesn't mean everyone gets off scot-free. The current rules regarding cost basis have the potential to create huge headaches for the loved ones of individuals who die with assets above a certain level.

Here are some of the key details of where things stand right now and how to think about estate planning given all of the uncertainty.

What's Happening in 2010

In a nutshell, the estate tax is a tax on the value of the property of a deceased person. If those assets don't add up to a certain level, the estate isn't subject to tax. But if the decedent's assets exceed a certain threshold—and that amount varies by year—the estate is subject to tax.

The estate tax was gradually phased out from 2002 through last year; in 2009, estates of more than \$3.5 million were not subject to estate tax. And in 2010, the estate tax is eliminated altogether, even for multi-million-dollar estates.

There are a couple of huge wrinkles, however. One, as I noted earlier, is that the estate tax could be reinstated for 2010, giving the IRS the ability to "claw back" estate taxes that weren't paid because of estate-tax repeal but that are due under whatever new estate-tax system Congress puts in place. The second big headache for families whose loved ones pass away in 2010 are the rules regarding the cost basis of inherited property. If you inherited assets before this year, you know that you were able to receive a "step-up" in cost basis. Say, for example, you inherited some Hewlett Packard HPQ stock from your grandfather, who paid \$10 each for the shares. If your grandfather passed away in June 2009, your cost basis would be the stock's price when he died—about \$37. So if you eventually sold the stock for

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\$55, you'd owe capital-gains tax on the \$18 in appreciation since you inherited it, not the \$45 spread between your grandfather's purchase price and your own sale price.

But that attractive step-up goes away in certain situations under the current estate-tax law. Spouses can receive a step-up in basis on \$3 million in inherited assets, and nonspouse beneficiaries can receive the step-up on inherited assets worth less than \$1.3 million. Those inheriting assets above those levels, however, will receive the decedent's own cost basis in the assets. That creates a headache not just because you could owe more taxes when you sell, but also from a record-keeping standpoint, as you'd have to sleuth around to find out exactly what your grandfather paid for his shares.

2011 and Beyond

Unfortunately, the estate-tax horizon isn't any less murky once you get beyond 2010. The estate tax is set to revert to its pre-EGTRRA levels in 2011, meaning that a 55% estate tax would be due on estates greater than \$1 million. Tax-code watchers have argued that Congress would be unlikely to leave such an onerous system in place. But as this year's convoluted system attests, anything is possible.

What to Do?

Given all the uncertainty and the fact that many attorneys aren't even sure what to advise their clients, it's not surprising that many individuals are in a state of estate-planning paralysis. So what should you do?

While it's true that you'd probably want to avoid a major rewrite of your estate plan at this juncture, it's important to recognize that estate planning is a lot more than just tax avoidance. Estate planning also involves drafting documents to ensure that your wishes are carried out if you die or become disabled—such as a living will. It also entails choosing individuals to act on your behalf—an executor, durable (financial) power of attorney, power of attorney for health care, and guardian if you have minor children. Drafting those documents and selecting those key individuals is important no matter what, but especially if you've recently had a major life change—for example, you've recently gotten married or had a child. Updating beneficiary designations is another important, and mostly evergreen, aspect of estate planning; estate-planning attorney Susan Jones provides some specific guidance in this article.

And while many tax pundits argue that the current rules regarding the cost basis of inherited assets will be eliminated once Congress revisits the estate tax, the current kerfuffle illustrates the importance of keeping good records on cost basis—the price you paid for individual securities in your taxable portfolio, including commissions and other expenses. Precise record-keeping of cost basis can not only aid in the estate-planning process, but also enables you to take advantage of more sophisticated tax-loss selling methods, such as specific share identification. Brokerage and mutual fund firms, as well as financial software packages, have begun providing increasingly sophisticated tools for tracking your cost basis. But setting up your own tracking system isn't difficult. Simply get in the habit of recording the name and number of shares you purchased, as well as the dollar amount and the date on which you purchased them. (Don't forget reinvested dividends.)