

Financially InKlein'd™

A Publication of FINANCIAL DESIGN CENTER, A Registered Investment Advisor
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FINANCIAL DESIGN
CENTER

Planning, Managing, and Protecting
Your Financial Independence™

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Are You Building Tax-Favored Distribution Assets™?

One of the key steps in planning for your financial independence is determining the size of the **Distribution Asset Nest Egg™** (“DANE”) that you, and your spouse, if married, will need on a specified date to fund your projected financial needs for the rest of your life (lives) without having to work another day after your targeted financial independence date.

Without going into all of the numerous financial and non-financial variables that one needs to consider when performing this calculation, suffice it to say that it is a complex, highly-customized exercise that requires ongoing review and updating in order to make sure that it is in fact achievable.

What Will Be in Your Asset Basket?

One of the critical, yet often overlooked, variables when calculating one's projected DANE is considering the fact that there are essentially two types of distribution assets that may potentially end up in your DANE: **Fully-Taxable Distribution Assets™** (“FTDA”) and **Tax-Favored Distribution Assets™** (“TFDA”).

TFDA include non-retirement plan mutual funds, exchange traded funds (ETF's), stocks, real estate, and business interests. Other non-retirement plan assets such as annuities and CD's are not **TFDA** since 100% of their income is taxable as ordinary income.

Most Retirement Plans Are FTDA

Most retirement plans, including 401(k) plans, while they are tax-favored on the front-end, generate fully taxable distributions, and, as such, are **FTDA**. While employees' contributions to 401(k) plans are tax-deductible and any appreciation in the value of plan assets, including matching employer contributions, is tax-deferred, these benefits can potentially be largely negated on the back-end when it comes time for taking distributions.

Depending upon the type of retirement plan, the tax-deductibility of the contributions that you made to the plan, the age at which you take distributions, and your income tax bracket, you may potentially only net 55 to 75 cents of each dollar that you withdraw from your retirement plans, with the difference payable to Uncle Sam. The actual amount that you and your heirs ultimately receive could be much lower if your estate is subject to estate taxes.

The TFDA Withdrawal Edge

While non-retirement plans, or **TFDA**, don't enjoy the upfront tax benefits and publicity of most retirement plans, they generally will outperform the latter when taking withdrawals.

For starters, whereas 100% of most retirement plan distributions are taxable as ordinary income at one's

highest tax rate up to 35% plus state taxes, only the appreciation portion of **TFDA** is taxable. Furthermore, the appreciation portion of **TFDA**, if held for longer than one year, is currently taxed at a favorable maximum federal long-term capital gain tax rate of 15%.

In addition, whereas you may take **TFDA** distributions at any age in any amount, this is not the case with retirement plan distributions. Unless you meet a specific statutory exception, pre-age 59-1/2 distributions from most retirement plans are subject to a 10% federal premature distribution penalty and post-age 70-1/2 distributions that do not comply with IRS' Required Minimum Distribution (“RMD”) rules are subject to a 50% federal penalty.

As an example of the power of **TFDA** vs. **FTDA**, suppose you have \$1 million each in a 401(k) plan and a living trust brokerage account, 30% appreciation in both accounts, you're in 33% federal and 7% state marginal tax brackets, and you withdraw 100% of all assets. You will net \$846,000 from your living trust account, or \$246,000, or 41%, more than the \$600,000 that you will net from your 401(k) plan.

Your ability to achieve financial independence and, by definition, not outlive your assets, is directly dependent upon the **FTDA** vs. **TFDA** composition of your DANE. Given this inherent fact, it is essential that you take a close look at the types of assets in which you are investing and have accumulated to date.

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