

# Client Bulletin

Smart Tax, Business & Planning Ideas from your Trusted Business Advisor<sup>SM</sup>

## Customization Comes to Target-Date Funds



According to Morningstar, target-date funds (TDFs) attracted nearly \$70 billion in 2015. Another research firm, Cerulli Associates, has predicted that 88% of new 401(k) contributions will go into TDFs by the end of 2019. As this market expands, new versions are appearing: the “custom” TDF has been labeled the fastest growing segment.

The rise of custom TDFs is somewhat ironic, as these funds are meant to be one-size-fits-all for investors. TDFs are on the short list of qualified default investment alternatives (QDIAs). Department of Labor (DOL) regulations allow retirement plan sponsors to put contributions by plan participants who do not specify investment

choices into a QDIA without being responsible for investment losses. That’s a prime reason for the growth of TDFs.

Now that custom TDFs are emerging, they help to point out that “regular” TDFs have cons as well as pros. If you invest in a TDF or if you’re considering one, you should know what’s inside the package, so you can decide on an appropriate strategy, going forward.

### Downshifting

As the name suggests, each TDF has a target date: 2030, 2035, 2040, etc. These dates are meant to indicate the year closest to a participant’s anticipated retirement date.

**Example:** Lynn Martin, age 40, begins a new job at a company with a 401(k) plan that includes a TDF series. She plans to retire at 65, so she chooses the TDF dated 2040, when Lynn will be 64.

A TDF typically will be a fund of funds. Thus, Lynn’s chosen TDF includes a variety of stock funds and bond funds, currently allocated in a manner that the fund company believes is suitable for someone 24 years from retirement.

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## Through the Roof

*The median existing home price for all housing types in April 2016 (latest data available) was \$232,500, up 6.3% from April 2015.*

## Trusted Advice

### Veering from the path

- ▶ If you are considering a target-date fund (TDF) for professionally managed asset allocation, look at the current glide path. Are you comfortable with this mix of funds and the plans for the future?
- ▶ Keep in mind that a TDF can change its glide path. These funds generally lost heavily in 2008, when the financial crisis occurred, so many TDFs decreased their equity exposure.
- ▶ The TDFs that changed glide paths in 2008 may have missed some of the subsequent stock market rebound, before moving money back into equity funds.

In this hypothetical example, Lynn's TDF now has 60% invested in equity funds and 40% in fixed-income funds. TDF funds have a "glide path," decreasing the exposure to stocks as the target date nears. Lynn's TDF might have 40% in equities and 60% in fixed income by 2040, providing less market volatility and more income for shareholders who are in or near retirement.

TDFs don't cease to exist at the target date. Instead, they continue on,

providing shareholders with the option of cashing in for retirement expenses or staying invested, just as would be the case with any mutual fund. Some TDFs reach their most conservative asset allocation at the target date and remain there in future years. Many other TDFs, though, continue on their glide paths by reducing equity exposure for another 5, 10, 15 years and sometimes even longer.

### Different strokes

Just as not all TDFs are alike, the same is true for participating employee groups. "Vocation and location" can make a difference, Morningstar has asserted, when designing custom TDFs. A relatively young group of technology employees in Silicon Valley, for example, may have a different approach to retirement planning than workers at an industrial plant in the Midwest. A company in the oil industry might better serve plan participants with a series of TDFs with less exposure to investments correlated with oil prices and energy stocks because employee job security in that industry is highly vulnerable to those trends.

TDFs can be customized in many ways, from tailoring the glide path to cherry picking underlying funds to including asset classes not found in standard TDFs. The constant, at least so far, is the expense involved in creating and administering custom TDFs.

For now, custom TDFs are usually offered by companies with retirement plans holding at least \$100 million of assets. As the concept evolves, custom TDFs may become available to smaller companies or even to specific employee groups within large firms.

No matter what type of TDF you might consider, look closely to see just how your money will be invested. Moreover, you should keep in mind that you can put together your own custom target date portfolio if you're willing to devote the time and effort to researching your own investments. Alternatively, you can seek a financial adviser with a proven record of developing individualized asset allocation strategies for clients as they head towards and through retirement. ■

## Did You Know?

**B**y the end of 2015, U.S. automated financial services known as robo-advisers managed \$50 billion in assets, up from \$16 billion in 2014. The market has been estimated to grow to \$2.2 trillion by 2020. Robo-advisers do what flesh-and-blood financial advisers do, but at a far lower cost. The field already has attracted major firms such as Vanguard, Schwab, and BlackRock.

Source: Bloomberg

## Drawing Down Your Portfolio in Retirement

Retirees often need money from their investment portfolio, if they have little or no earned income. For many seniors, tax-efficient withdrawals require two levels of decisions. First, should the dollars come from regular taxable accounts or from tax-deferred accounts such as IRAs? Second, regardless of where the money

is coming from, how will a portfolio be liquidated to provide spending money?

### Taxable or tax-deferred?

Some people enter retirement holding an IRA as well as a taxable account. If cash is needed, they often choose to take the money from the taxable account.

**Example 1:** Joy Larson needs \$4,000 a month from her portfolio in retirement to supplement her Social Security income. The money in her traditional IRA was rolled over from Joy's 401(k) plan at work. All the money in her 401(k) was pretax, so IRA withdrawals will be taxed at ordinary income rates. Consequently,

Joy decides to take money from her taxable account. Those withdrawals may be tax-free, if no investment gains are triggered. And, even if Joy takes some gains, they may be taxed at favorable long-term capital gains rates.

Drawing down the taxable account may be a common practice for retirees. However, there may be drawbacks. In time, the taxable account might be depleted, leaving only pretax IRA money for distributions later in retirement. Those distributions may be heavily taxed at whatever tax rates apply in the future.

In addition, holding on to IRA money can lead to a sizable amount of tax-deferred dollars left to your heirs. Your beneficiaries will have required minimum distributions (RMDs) from the inherited IRA, and those distributions probably will be taxable. (Special rules apply to IRA money left to a surviving spouse, but those dollars eventually may pass to younger relatives.) If the IRA beneficiaries inherit while in their prime working years, the tax on those distributions could be especially steep.

On the other hand, if you take some cash from your IRA and leave highly appreciated assets in your taxable

account, you may be able to pass those appreciated assets to your heirs. Under current law, they'll get a basis step-up, usually to a date-of-death value. Then, your heirs can sell the assets and avoid paying tax on the appreciation during your lifetime.

The bottom line is that you might want to use some IRA money as well as money from taxable accounts to cover living expenses in retirement. This approach may be helpful before you reach age 70½, when RMDs from your IRA begin. Withdrawing some money from your IRA before 70½ may help you hold down taxable RMDs in the future.

### Know how to fold 'em

Regardless of where the money will come from, you should have a plan for drawing down your portfolio in retirement. Your specific circumstances will influence your decisions, but one approach is to start retirement with a sizable "cash bucket." This money can be used for living expenses, regardless of what happens in the financial markets.

**Example 2:** In example 1, Joy Larson needs \$4,000 a month from her portfolio in retirement, or \$48,000 a year. Joy decides she wants enough

cash to cover three years' outlays, or \$144,000. Therefore, in advance of her retirement, Joy puts together \$144,000 in bank CDs and money market funds. This money can flow into her checking account to help pay her bills.

From time to time, Joy will liquidate other assets to replenish her cash bucket. There are many ways to do so, so Joy should have a plan. For instance, she may check her asset allocation every year to see whether it's still in keeping with her current wishes. Suppose Joy wishes to keep a 50-50 asset allocation between stocks and bonds, but a stock market slide has tilted her portfolio towards bonds, which have been stable. Then, Joy might sell some bonds and bond funds, putting the proceeds into her cash bucket while bringing her portfolio into a better balance.

No portfolio drawdown plan will work for everyone, but you should approach retirement with a well-reasoned plan and attempt to stick with it. Having a substantial amount of cash may enable you to ride out any market downturns, while having a thoughtful mix of equities and fixed income can provide income and growth potential throughout your retirement. ■

## Setting Paid-Time-Off Policies

Employers may think it's ironic that would-be workers often focus on how much time they *won't* be working, when they consider job offers. However, it's clear that offering time off may help to attract and retain valued employees. For business owners, the key is to develop a policy that provides flexibility and downtime without harming the company's productivity.

Broadly speaking, company-paid days off fall into two categories. One is holidays: Christmas, New Year's Day, Thanksgiving, Fourth of July, etc.

Many if not most companies are closed those days; sometimes the day before or after is considered a holiday as well. Generally, around 10 paid holidays a year is the norm. Except for special circumstances, you probably want all of your workers taking those days off.

Beyond holidays, the second category includes days referred to as "paid time off" or PTO, which are chosen by employees. They



include vacation and sick or personal days. Some companies put their PTO

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into separate buckets, one specifically for vacation time and another for sick or personal time, and include separate rules for how each type of PTO is to be used. In this case, integrating the different types of PTO (vacation and other) should be explained to employees, to avoid misunderstandings.

**Example 1:** Jim Mason takes two weeks' vacation in late summer, before and after the Monday of Labor Day. His company has told Jim that he will be charged for nine vacation days, rather than 10 due to the paid company holiday on Labor Day.

What if Jim takes an unapproved personal day before or after his approved vacation? Company policy likely states formally that such absences will be accounted for somehow (against vacation days or sick days, perhaps, or subject to discipline if Jim cannot provide a valid reason for his absence).

## Combination plans

Some companies are moving away from offering the separate time-off categories of vacation days and sick or personal days and using a single PTO category.

**Example 2:** Karen Anderson works for a company that offers 20 days of PTO each year. She can use them as she wishes, for any purpose. The advantage, to the company, is the ease of tracking a single PTO category, rather than different subcategories of PTO.

On the other hand, this arrangement may lead employees to try and use all 20 days as vacation each year. Fearing to lose a valuable vacation day, a worker might come in sick, which could lead to poor job performance and illness for coworkers. Companies initiating a PTO program might explain how the plan is intended to work and encourage employees to use their time for illness as needed.

With any type of PTO plan or other time-off plan, all details should be formally covered. If some allowable days are not used in a calendar year, can they be carried over? Is there a maximum carryover? How long are those days eligible to be used? Moreover, your company's plan or plans should comply with the federal Family and Medical Leave Act as well as with any state or local laws that apply.

Besides carrying over PTO opportunities, companies may offer employees the right to cash in unused PTO days. Such plans can lead to the issue of "constructive receipt," subjecting the employer and employees to paperwork hassles and additional income tax obligations. If your company has such a cash-in plan for unused PTO days, or is considering one, our office can address the possible tax issues. ■

## TAX CALENDAR

### SEPTEMBER 2016

#### September 15

**Individuals.** If you are not paying your 2016 income tax through withholding (or will not pay in enough tax during the year that way), pay the third installment of your 2016 estimated tax. Use Form 1040-ES.

**Employers.** For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in August if the monthly rule applies.

**Corporations.** File a 2015 calendar-year income tax return (Form 1120) and pay any tax, interest, and penalties due. This due date applies only if you timely requested an automatic six-month extension.

Deposit the third installment of estimated income tax for 2016. Use the worksheet Form 1120-W to help estimate tax for the year.

**S corporations.** File a 2015 calendar-year income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic six-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

### OCTOBER 2016

#### October 17

**Individuals.** If you have an automatic six-month extension to file your income tax return for 2015, file Form 1040, 1040A, or 1040EZ and pay any tax, interest, or penalties due.

**Employers.** For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in September if the monthly rule applies.

**Electing large partnerships.** If you were given an additional six-month extension, file a 2015 calendar-year tax (Form 1065-B).

#### October 31

**Employers.** For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2016. Deposit any undeposited tax. (If your tax liability is less than \$2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 10 to file the return.

For federal unemployment tax, deposit the tax owed through September if more than \$500.