October 2015

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MALLARD ADVISORS

Comprehensive Financial Planning & Wealth Management Solutions

THE QUARTERLY MALLARD CALL

Notices

Bill will be out of the office November 4th through November 6th to attend a conference presented by the Alliance of Comprehensive Planners.

The office will be closed for Thanksgiving on Thursday, November 26th and Friday November 27th. We will also be closed during the last two weeks of December.

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When sending confidential and/or financial information to us, please remember to use the **secure *ShareFile* link** contained at the bottom of each of our email signatures rather than using the attachment function of your email software.

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Build Wealth By Paying Taxes

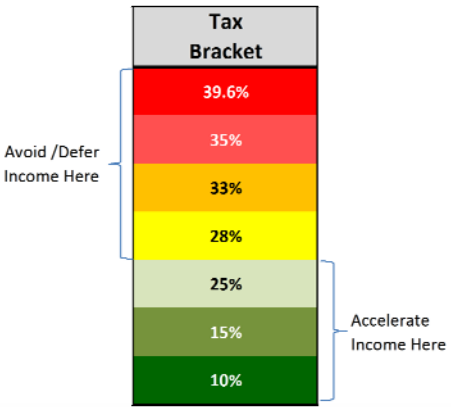
William D. Starnes

What if I told you that you could build wealth by paying taxes—and paying them now instead of later? Most clients don't want to pay taxes at all, let alone sooner rather than later. In fact it is common wisdom to defer income taxes as long as possible. How do you defer income and therefore taxes? The following table shows some typical income acceleration / deferral strategies.

Income Acceleration	Income Deferral
Remove money from before-tax vehicles such as a 401(k) or IRA	Place money into before-tax vehicles such as a 401(k) or IRA
Convert IRA to Roth IRA	Do Not Convert to Roth IRA
Begin Taking Social Security	Defer Taking Social Security
Sell Appreciated Stock	Hold Appreciated Stock
Cash in U.S. Savings Bonds	Buy/Hold U.S. Savings Bonds
Delay Charitable Contrib.	Accelerate Charitable Cont.

Deferring income makes a lot of sense—especially during the years where income is quite stable or high. However, it is also true that income deferral (and therefore tax deferral) is the wrong strategy at other times. **For many wealthy and retired clients, a tax-deferral strategy can result in getting clobbered with higher taxes down the road, at higher tax rates than you would have otherwise paid today**. So, what if you could realize income now (in order to pay a smaller tax) instead of realizing it later and (paying a larger tax)? If you have to realize this income at some point anyway, would you rather realize it now at a lower tax rate, or later at a much higher tax rate? This multi-year tax planning is called ***Tax Smoothing*** and it can build wealth by saving money on taxes.

Currently, there are seven tax brackets. – 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%. As your income rises, it fills the lower brackets and then moves to the next higher bracket. For example, for married clients the first $18,000 of taxable income is taxed at 10%, the next $55,000 is taxed at the 15% tax rate, etc. With a tax smoothing strategy, you would avoid/defer income out of the higher tax brackets and accelerate it into the lower tax brackets.



However, this is not done on just an annual basis. The biggest benefits are realized

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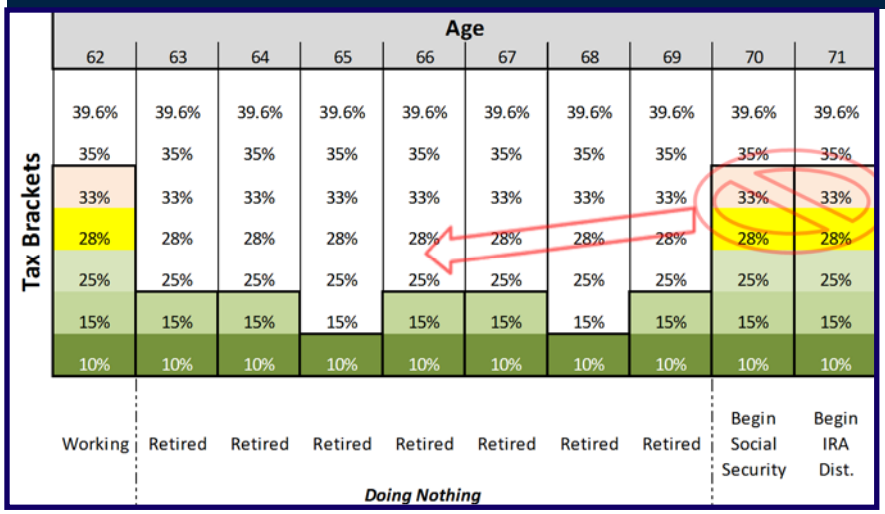

Tax Brackets	Age 62	63	64	65	66	67	68	69	70	71
	39.6%	39.6%	39.6%	39.6%	39.6%	39.6%	39.6%	39.6%	39.6%	39.6%
	35%	35%	35%	35%	35%	35%	35%	35%	35%	35%
	33%	33%	33%	33%	33%	33%	33%	33%	33%	33%
	28%	28%	28%	28%	28%	28%	28%	28%	28%	28%
	25%	25%	25%	25%	25%	25%	25%	25%	25%	25%
	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%
	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%
	Working	Retired	Retired	Retired	Retired	Retired	Retired	Retired	Begin Social Security	Begin IRA Dist.

Doing Nothing

when tax smoothing evaluates your anticipated tax rates over time as illustrated in the table above. Looking at tax rates this way is especially useful during the years where there is much variability in income (and therefore tax rates). Generally these variable years occur between the time of employment and age 70. When there is a lot of *variability* of income, there is a lot of *opportunity* for tax planning and tax savings.

To take advantage of tax smoothing, you must know which acceleration and deferral techniques fit with your own projection of taxable income and future tax brackets. Even more so, you much know which tax brackets to maximize. Some clients should maximize the 15% tax bracket, while others should maximize the 25% tax bracket.

Take a moment to study the chart above. Notice how "bumpy" it is. It is bumpy because this client's income is changing quite dramatically. Think of tax brackets as buckets you may want to consciously fill with income in order to take advantage of low rates now. Then you don't have to face them ***as severely*** in the future.

Low brackets are something you USE—not celebrate.

The chart to the left shows a very typical, multi-year tax situation for a soon-to-be-retiree. Unfortunately, most people just can't see these future changes, and therefore can't take advantage of a tax-bracket smoothing strategy.

But what if you were able to see these coming changes and knew how to shift income out of the 28%-33% brackets and into the 15%-25% brackets.

I do multi-year tax bracket smoothing with all full-service clients. Let's take a look at a typical client situation using data generated from my financial planning software. The chart below illustrates a typical pre-planning scenario and how taxable income fills up each tax bracket over time.

This married couple, who are both 61 years old are working and earning enough where each additional dollar of income is being taxed at a rate of 39.6%

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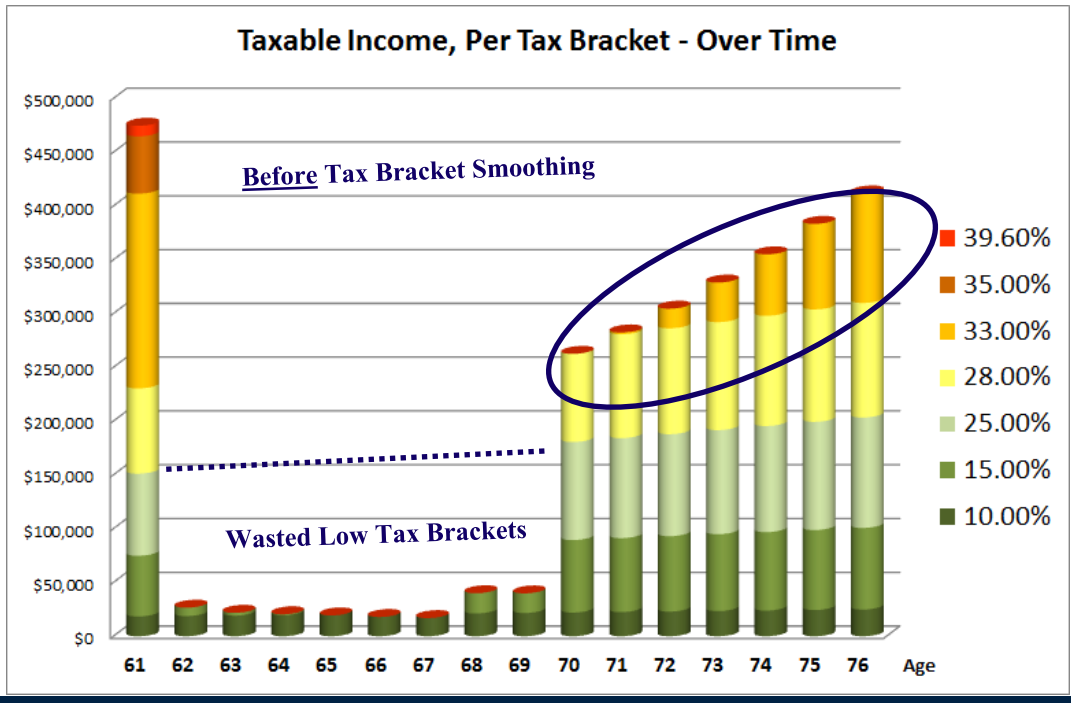
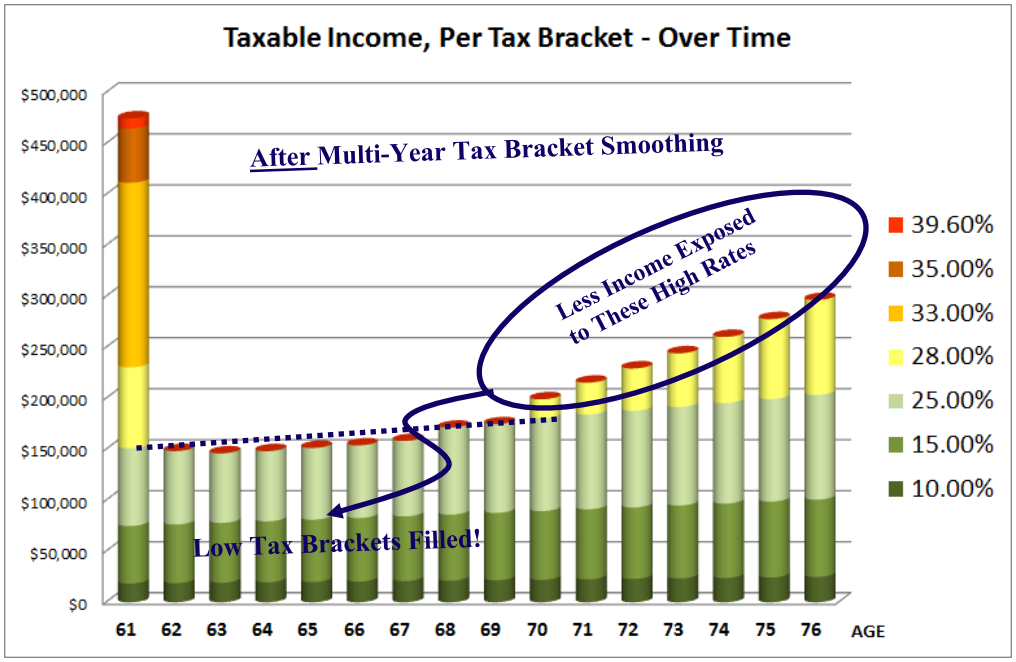


(i.e., income over $465,600 or so). After retirement (for the next several years at least), their income drops them into the 15% tax bracket. At age 70+ (between taxable Social Security income and required IRA distributions), they are catapulted into the 28%-33% tax bracket. Beginning at age 73 they will remain in the 33% tax bracket for the rest of their lives!

These "bumpy" tax brackets present a limited opportunity to shift some of this future income into the present, which also shifts it from being taxed at these future higher rates to current lower rates.

For example, if you were to realize/accelerate taxable income by taking just enough money out of your IRA to fill the desired lower tax brackets, this would then reduce your future required IRA distributions beginning at age 70 & ½. This would result in reducing these distributions to the point where your tax rate was no longer driven up into the 33%+ tax brackets. Therefore, most IRA distributions would be paid at only the 25%-28% tax rate rather than 33% as illustrated in the chart on the right.



You can see that the 15%-25% tax brackets have been filled for these 8 years (age 62-69). In addition, you will also notice that the future tax brackets have less income exposed to them as a result of accelerating this income.

If you have stuck with me this far, you may be saying: "Bill, this sounds amazing, the graphs are slick, and it may make logical sense, but will doing this really improve my financial security? Does this really increase my wealth?" The answer is YES and I have the tools to prove it.

In order to quantify the value of this type of planning, we calculate the value of all investments at the end of this couple's plan BEFORE doing income tax bracket smoothing. We then illustrate tax bracket smoothing via a series of Roth IRA conversions (in this example). Everything else is held constant in order to see the true value of this type of multi-year tax bracket smoothing. The bottom line is that this type of tax bracket smoothing increased the couple's total portfolio by over $342,000! Inflation is not part of this $342,000. Instead, $342,000 is the real value of this type of planning. Would you like to increase your wealth simply by moving the right amount of money from one account to another in the right years?

It has become so ingrained to defer income at all costs. However, when you do multi-year tax planning and can see the big picture, deferring income is not always the best strategy. Instead paying taxes now can actually build wealth!

Bill Starnes is the founder and senior advisor at Mallard Advisors, LLC

Investment Commentary

After almost four years, the stock market finally did what it usually does on an annual basis - **corrects** - where a correction is defined as a 10%+ decline in the S&P 500 Index. In fact (at least thus far) it has been a relatively mild correction. I have mentioned many times that the average intra-year decline in the S&P 500 (since 1980) has been about 14%. The most difficult part of this correction was that it occurred very quickly with an 11% loss in just seven days ending August 25th.

As of today, from the highs reached March 21, 2015, the S&P 500 is now down roughly 9%.

This year-to-date, the U.S. stock market (S&P 500) is down 5.4%. When you look at this year-to-date decline, you see a relatively small loss. But many **all-equity investors** are remembering they were 10%-15% wealthier just a couple of months ago. It's tough to watch the value of your portfolio go down fast, but it's also worth remembering that people have been predicting a significant downturn erroneously for the better part of six years. Now that a downturn has finally arrived, it hasn't been terribly painful, **mostly giving back gains that were posted in the beginning half of the year**.

International stocks and small caps are down (-6.5%) this year-- even more than U.S. stocks. This year-to-date, emerging markets (-18%) and energy (-22%) are down the most.

Who is to blame? The Fed? The Chinese government? Commodity prices? While there were many excuses for the loss of confidence in the stock market, in reality the cause appears to have been mainly psychological as opposed to fundamental.

Regardless of why the markets have been uncooperative, **do investors really believe the enduring values of these great U.S. companies should have suffered an 11% decline in just seven days in August?** They may, but they should not. Instead, we were....***just due*** for it.

Markets (like the U.S. stock market) are volatile, but what is more stable is the long-term intrinsic value of the larger, better financed, more profitable companies in America (not to mention the world). Therefore, allow the lower prices to encourage you to buy great companies at cheaper prices than we could have just three short months ago.

Total Return as of 09/30/2015

	Sept	3rd Qtr	YTD	Last 12 Months	*Annualized* 3 Years	*Annualized* 5 Years
GLOBALLY DIVERSIFIED BALANCED PORTFOLIO**						
60% Equity / 40% Bond	-1.8%	-5.8%	-4.0%	-3.1%	5.8%	6.4%
STOCKS						
Larger-Cap	-2.5%	-6.5%	-5.4%	-0.8%	12.2%	12.8%
Smaller-Cap	-4.5%	-10.3%	-6.7%	-0.3%	12.3%	12.8%
International - Developed Mkts	-3.9%	-11.6%	-6.9%	-10.8%	3.1%	2.1%
International - Emerging Mkts	-3.3%	-18.2%	-15.2%	-18.4%	-4.8%	-3.5%
Real Estate	3.0%	2.0%	-4.5%	9.2%	9.2%	11.7%
Inflation Hedges*	-9.0%	-20.0%	-21.9%	-31.5%	-8.9%	-3.2%
BONDS						
U.S. Investment Grade Bonds	0.8%	1.2%	0.9%	2.6%	1.5%	2.9%
Global Bonds	0.6%	1.4%	0.6%	3.1%	-	-

** Each asset class is represented by a relevant Vanguard Index fund except for Inflation Hedges where the Morningstar Category average for **"Natural Resources"** is used.*

*** The portfolio is represented by the DFA Global Allocation Fund (60% Equity / 40% Bond)*