July 2020

Inside This Issue

Notices

Mallard E-Mail Update

We strongly encourage all clients to read our E-Mail Updates (which are different from this quarterly newsletter). They may contain important information that is relevant to your situation. It is always best to call us if you think something may apply to you so that we can discuss it.

If you are not receiving our E-Mail Updates, let us know by sending us an e-mail requesting to be added to our list.

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MALLARD ADVISORS LLC

Comprehensive Financial Planning & Wealth Management Solutions

THE QUARTERLY MALLARD CALL

Opportunities & Perils of No 2020 RMDs

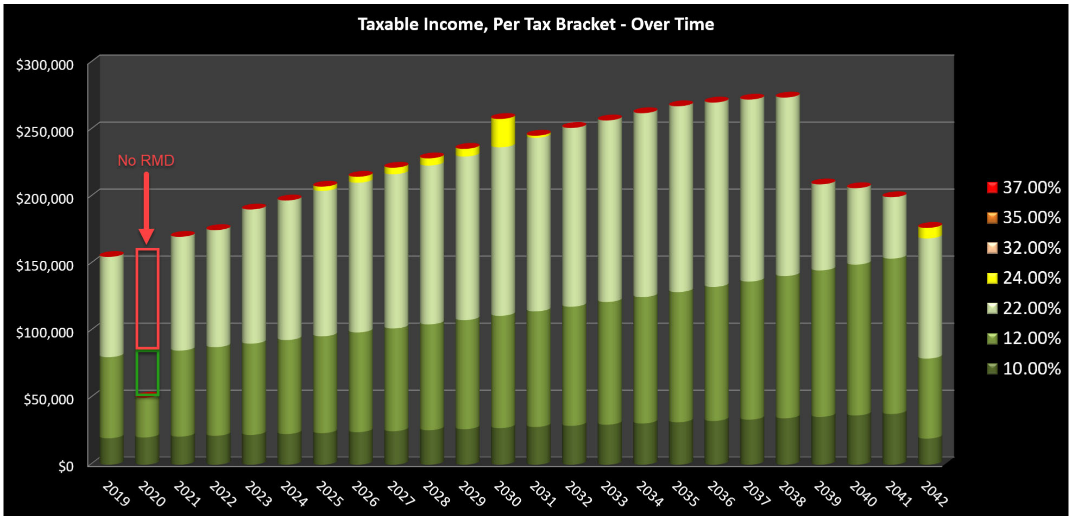
William D. Starnes

In response to the unfolding COVID-19 global pandemic, the Coronavirus Aid, Relief, and Economic Security ("CARES") Act was signed into law in late March 2020.

For our clients (over age 70), one of the most significant aspects of this law is the ability to skip required minimum distributions (RMDs) from retirement accounts for 2020. In other words, retirement account owners now have the ***option*** of taking as much or as little a distribution from their IRAs in 2020.

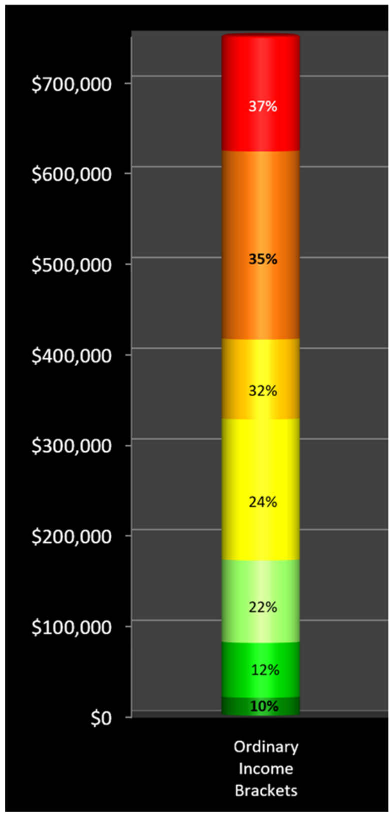
The purpose of this law is to help minimize the impact of retirement withdrawals occurring in the midst of a bear market (i.e. selling low). A similar provision was enacted in 2009 for the same reason. For 2020 this provision is broad and applies to IRAs, SEP IRAs, SIMPLE IRAs, 401(k)s, 403(b)s, and Governmental 457(b) plans. Furthermore, the relief applies to both retirement account owners, as well as to beneficiaries taking inherited IRA distributions. **The option of skipping required account distributions presents great opportunities, but also some perils.**

Many of our clients do not need to take their RMDs for cash flow purposes. Therefore, they want to skip them in order to avoid the taxable income these distributions would otherwise create. For example, a 75-year old married client with a $2mm IRA must take an IRA distribution of about $80,000. This is $80,000 of taxable income. Let's say this client also has $500,000 in a liquid cash savings account. If they needed the $80,000 for cash flow, they could simply take this from the cash account, leaving the $80,000 in the IRA. This would eliminate the $80,000 of taxable income. Taking the $80,000 from the cash account would NOT generate any taxable income. This would have a significant positive impact upon this client's tax liability in 2020, and presents a great opportunity for tax savings.



If you really think about it, what if this client is typically in the 22% Federal Tax Bracket (as illustrated in the graph on the first page). If they are now (due to NO RMD) in the 12% tax bracket, might this create a once-in-a-lifetime opportunity in 2020 (the second column in the graph on the first page)?

This client will likely never see the 12% Federal Tax Bracket again. In fact, at the first death, the surviving spouse will immediately be exposed to even higher taxes due to the "single" tax brackets being more progressive than the "married tax brackets". This can be seen in the graph on the prior page. Note how the brackets change in the year 2042.



As income rises, it will progressively be exposed to the tax brackets shown in the image on the right. The astute reader might say, *"Since I will never see the 10%-12% Federal Tax Bracket again, might it be a good idea to create some income now so that I fill up (or fully utilize) the 12% bracket? That way the same income does not get taxed at the 22%+ bracket in the future".*

They would indeed be asking the right question. So, how do you create taxable income? You could take a voluntary IRA distribution, cash in U.S. Savings Bonds, sell some highly appreciated stock, or perform a Roth IRA Conversion.

In my opinion, performing a partial Roth IRA conversion is usually the best method of creating taxable income. This is because the converted dollars are still liquid if needed, but if not, the future withdrawals will be 100% tax-free instead of taxable (if it remained in the IRA).

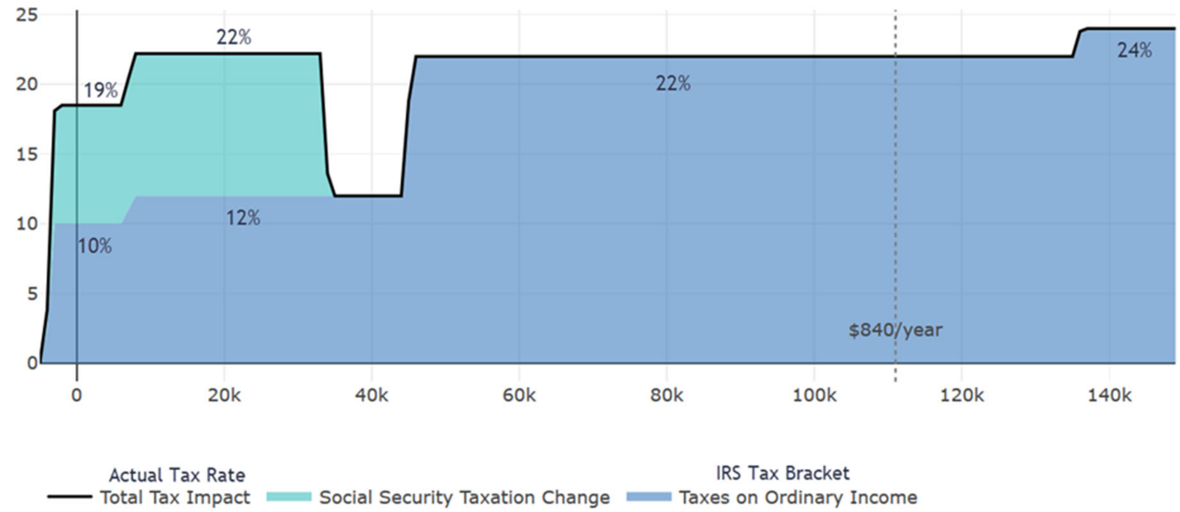
Let's say we have a client who wants to take advantage of this unusual opportunity to accelerate income into the 10%-12% tax bracket in order to avoid higher tax brackets in the future. They estimate that without the RMD this year, their taxable ordinary income will be about $8,000 (after the large standard deduction of $27,400 brings their total income down). They look at the tax tables and see that ordinary income from the current $8,000 up to $80,250 will be taxed in the 10%-12% Federal Tax Bracket. Therefore, acting conservatively they conclude they will perform a $35,000 Roth IRA conversion to ensure they pay a maximum of 12% tax on this.

Here is the rub. Just because the tax tables say your $35,000 of additional income will largely be subjected to the 12% Federal Income Tax Bracket, this does not actually mean you will pay about 12%. ***In fact, our client would actually pay 21% of this conversion in tax!*** What? This is not much of a tax savings compared to their normal 22% federal tax bracket. Therein lies the perils of trying to take advantage of the lack of RMDs for 2020.

The problem with tax planning is that it is complicated, and tax advisors (and their clients) must distinguish between the published IRS Tax Brackets and the ***actual*** Marginal Tax Rates they will actually pay on the next dollar of taxable income.

Now, normally, you do pay what the IRS tax tables say, but sometimes you pay more...much more. How is this possible? It is possible because there are many moving parts to the tax calculation. If you were to add one dollar of additional income, you not only pay the 12%, but this dollar of additional income may trigger other negative tax consequences. For example, that additional dollar of income can also result in higher Medicare premiums, a larger amount of your Social Security being subjected to taxation, the loss of tax credits, or many other unintended consequences.

Most people can visualize the tax brackets as shown in the image on this page. Looking at it this way is simplistic and does not tell the whole story. Should this client perform a $35,000 Roth Conversion and will all that income be taxed at the 12% income tax rate?



Let's take a closer and more nuanced look at their tax situation. The blue area in the graph on this page is simply laying out the published IRA tax brackets along the vertical axis. The client's taxable income is represented by the solid vertical line on the left side of the graph. If the client creates additional income (via a Roth IRA Conversion), their income would rise, and the line would *move to the right* and they would move up in tax brackets.

Focus on the blue area and you can see that as income increases, they move from 10% (their current tax bracket) to 12%, 22%, and 24%. While the blue area is indeed the IRS ***tax bracket*** based upon the client's ordinary income, it does not represent the percentage of tax they will pay on the next additional dollar of income (i.e., the actual Tax Rate).

The actual ***tax rate*** for the client is shown by the black line that is floating on top of the colored area. Currently they are in the 19% tax rate, and then (as income starts to rise), they will move to the 22% tax rate. In other words, if this client were to perform a $35,000 Roth IRA conversion, they would be paying 19% on the first $6,000 of the conversion, then 22% on the balance of the conversion. Again, the blue area is what the IRS tells us we will pay, but at Mallard we are able to calculate the ***actual*** tax rate that you would pay based upon your own unique tax situation. The differences are sometimes significant, and therefore, important in inadvertently creating income in higher than desired tax rates!

Why is the actual tax rate higher than the published IRS tax bracket? In this case, it is solely because each additional dollar of income subjects more Social Security income to taxation.

This will continue until a full 85% of Social Security ends up taxed. Then this effect will drop away, but only temporarily. The 10% tax bracket is a fiction for this client (and many retirees). The 12% bracket is also almost never seen. While you are indeed adding income that is being taxed at 10%, you are also inadvertently increasing the amount of your Social Security that gets taxed. This results in far more tax that must be paid than considered at first glance. The net effect is that with each additional dollar of income for this client, it is ultimately creating a tax liability that is 19%-22% of the client's income (their actual tax rate). This is what has been called the Social Security Tax Torpedo!

In 2020, many clients are provided with a "once-in-a-lifetime" opportunity to avoid taking their IRA distributions. This also presents an opportunity to create income in lower (never to be seen again) tax rates. However, navigating your taxable ordinary income in a way that avoids creating income at unexpectedly high tax rates is riddled with perils.

Be sure your advisor can calculate your 2020 tax, and build multiple scenarios to take advantage of waived RMDs without being hit by the Social Security Tax Torpedo or other such perils.

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

Market Commentary

The first six months of 2020 saw the advent of the worst global public health crisis since the 1918 influenza pandemic. In response, the world locked down, putting the economy into a kind of medically induced coma. The immediate effects were a severe and nearly instantaneous economic recession (accompanied by record unemployment), and the fastest, deepest collapse in stock prices in living memory.

Specifically, the U.S. stock market dropped from an all-time high on February 19th to a bear market low (so far) on March 23 with a total decline of 34% in 33 days. There is no historical precedent for this steep of a decline in such a little time. Confounding, it then posted its best 50 days in history.

Large U.S. stocks fell by 20% during the first quarter of 2020, then they rose by 20% during the second quarter. So, I guess a 20% drop followed by a 20% rise seems fitting for the year 2020. Of course, it takes more than a 20% rise to make up for a 20% loss, which is why large company U.S. stocks are still down 3.2%. With everything that's going on in the world and in our lives, seeing that large U.S. stocks are down about 3% feels both miraculous and odd (like the market must be missing something).

International investors experienced the same lurching investment ride as U.S. stock holders, but with a shallower recovery. The broad-based Vanguard Total International Stock Index of businesses in foreign economies lost 24.3% in the first quarter, and then gained back 18.1% in the second quarter. Year to date, the index is down 10.7%.

What is going to happen in the second half of this year? I won't answer that, not only because I don't know, but because we are not investing for six months. We are long-term, disciplined, and patient investors with an investment philosophy that does not include decisions that developed around what may or may not occur in the short-run.

In fact being willing to say, "I don't know", and sticking to our investment philosophy has been difficult, but critical in getting market returns that have been decent considering the circumstances. There must be thousands of economists and professional active investors around the world, and it is obvious that the economic events and stock market moves **were forecast by absolutely none of them**. If you were one of those individuals driven to sell stocks to "get out" before things got worse, then you also know how impossible it was to successfully profit from the confounding stock market moves of this year.

Summary of Asset Class Total Returns *(as of 06/30/2020)*

Asset Class*	Ticker	June	2nd Qtr	YTD	12 Months	*Annualized* *3 Year*	*5 Year*	*10 Year*
GLOBALLY DIVERSIFIED BALANCED PORTFOLIO**								
60% Equity / 40% Bond	DGSIX	1.9%	13.8%	(4.1%)	1.7%	4.4%	4.9%	7.3%
STOCKS								
Larger-Cap	VFINX	2.0%	20.5%	(3.2%)	7.4%	10.6%	10.6%	13.8%
Smaller-Cap	NAESX	2.5%	26.7%	(11.5%)	(5.7%)	3.9%	5.3%	11.5%
International - Developed Mkts	VGTSX	4.2%	18.1%	(10.7%)	(4.2%)	1.0%	2.4%	5.2%
International - Emerging Mkts	VWO	7.2%	19.8%	(9.6%)	(3.1%)	2.0%	2.0%	3.0%
Real Estate	VGSIX	2.4%	13.5%	(13.9%)	(7.0%)	2.1%	5.2%	9.6%
Inflation Hedges	*	2.4%	26.2%	(15.2%)	(12.8%)	(2.9%)	(1.3%)	1.6%
BONDS								
U.S. Investment Grade Bonds	VBMFX	0.7%	3.0%	6.3%	8.9%	5.2%	4.2%	3.7%
Global Bonds	VTIFX	0.5%	2.2%	2.4%	4.1%	5.0%	4.5%	N/A

** 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. All data is provided by Morningstar and includes reinvested dividends.*

** All returns are net of (i.e., after) fund fees, and include reinvested dividends.*

** Past performance is not indicative of future results.*

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