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Take the End of Year to Improve Portfolios and Reduce Taxes

Are you letting financial opportunities fall between the cracks? You could be, if you wait for the New Year to review 2004's finances. A review in late November or early December could allow you to improve your portfolio, avoid losses and reduce taxes.

Be cautious that you don't allow the tax tail to wag the investment dog. Investment decisions should be made for investment reasons, not tax reasons. However, tax benefits should not be ignored.

Diversification

Has your asset allocation fallen out of its intended ranges? How does your portfolio compare to benchmark sector weightings? Has your ratio of *Value* to *Growth* stocks become skewed? Over the course of a year, or several years in some cases, investment portfolios will tend to develop unhealthy asset class concentrations from the varied performance of stock and bond markets. Even the most perfectly constructed portfolios fall victim to all to these pitfalls.

In addition to regaining necessary diversification, a pre-year end review can add some valuable tax benefits. Large concentrations will create risk, even with historically sound companies. The abrupt portfolio losses resulting from Merck's recent negative experience with Vioxx is an example.

Rebalancing a portfolio is unnatural. However, it is a key way to reduce risk. While rebalancing is the mantra of successful investing, most investors find it emotionally difficult to sell high and buy low.

As you look at reducing over-concentrations, year-end provides an opportunity to spread tax liability over two years – a December sale and a January sale. This is important as recognition of substantial capital gains in one year could be an Alternative Minimum Tax (AMT) trigger. Additionally, you can manage capital gains distribution by specifying the shares to be sold as opposed to allowing the FIFO (first-in-first-out) rules to apply in an unspecified sale. Finally, capital gains taxes can be eliminated altogether by gifting the appreciated stock to a qualifying charity – this assumes that you plan on making a charitable contribution in addition to reducing an investment position. Be aware that capital gains taxes have been reduced to 15% and are typically lower than earned income taxes.

Additionally, it is important to eliminate under-performing investments. While it can be difficult to sell a poor performer, it provides a good opportunity to harvest losses to offset capital gains. Realize that capital losses in excess of capital gains can be carried over for future years to offset subsequent income.

Take your money and run

Individuals must begin taking Required Minimum Distributions (RMD) from retirement plans and IRAs at age 70 ½, even if they do not want or need the money. These distributions (except for the initial distribution) must be made by calendar year-end. The IRS imposes a 50% penalty on any shortfall of the RMD, much more onerous than the better known 10% penalty for pre-59 ½ distributions.

IRAs

There is good news concerning IRAs. The allowed maximum contribution to IRAs will be increased in 2005 from the current $3,000/yr to $4,000/yr. People age 50 or older are eligible for a provision, which allows for a 4,500 'catch-up' contribution per year.

Depending on you income it may be beneficial to convert a traditional IRA to a ROTH IRA.

Beneficiaries

Use year-end as an opportunity to review the beneficiary designations on retirement plans, pensions, IRAs, annuities and life insurance. To the surprise of many people, a beneficiary designation overrides the direction of valid wills, trusts and other estate planning documents. Assets that allow for a beneficiary designation pass by virtue of contract law and are not included in or subject to probate.

Ongoing Savings

Be certain that you are increasing retirement savings as the maximum contribution limits increase. While the percentage remains constant at 15%, higher earners will be allowed to save more in 2005 – for example, 401(k) limits increase from 13,000 in 2004 to 14,000 in 2005. Additionally, if you are 50, you are eligible to participate in 'catch-up' savings – an additional $4,000/year can be contributed to most retirement plans. Be certain to notify your Human Resources Department if you will be increasing your retirement contributions.

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