MIRACLE MILE ADVISORS

It’s Not What You Make, It’s What You Keep (Hint: Taxes)

How Can I Pay Less?

At Miracle Mile Advisors, the cornerstone of our investment thesis is to provide a tax efficient, customized investment solution for our clients. Although the 2013 tax law changes made this tax season incredibly painful for many taxpayers, we feel it is important to remind people that a smart investment plan incorporates smart tax planning. This quarter, we’d like to present some basic tax saving ideas and introduce a few lesser known vehicles that can help yield big tax savings both in the short-run and in the long-run.

Why Were My Taxes So High In 2013?

Tax rates went up across the board in 2013, as the social security tax reverted back to its original 6.2% from a temporarily reduced 4.2%. Federal income taxes rose, as did dividend income and capital gains taxes. With these changes, nearly all individuals felt the pain of higher taxes in 2013 and will seek to mend their wounds in 2014.

Tax Comparison	California		New York		Nevada	
Type	2012	2013	2012	2013	2012	2013
Federal Income Tax	35.0%	39.6%	35.0%	39.6%	35.0%	39.6%
State Income Tax	12.3%	12.3%	8.8%	8.8%	-	-
Obamacare	-	3.8%	-	3.8%	-	3.8%
Social Security	4.2%	6.2%	4.2%	6.2%	4.2%	6.2%
Short Term Capital Gains	**47.3%**	**55.7%**	**43.8%**	**52.2%**	**35.0%**	**43.4%**
Long Term Capital Gains	**27.3%**	**36.1%**	**23.8%**	**32.6%**	**15.0%**	**23.8%**

**All taxes assume individual is in highest tax bracket*
***ST/LT Capital Gains rate includes state taxes and Obamacare*

Asset Allocation Matters

An important aspect of any investment plan is diversification. However, what one might not think about are the tax ramifications that are associated with different asset classes. After-tax returns are often not what they seem. For example, traditional fixed income investments are taxed at ordinary income rates, while municipal bonds avoid taxation on interest all together. Asset allocation can have a substantial effect on investment returns.

After Tax Returns By Asset Class				
Asset Class	**Average Return**	**Long Term Tax Drag**	**Short Term Tax Drag**	**After Tax Return**
US Equities	10.46%	-2.11%	-0.82%	**7.53%**
International Equities	5.73%	-1.16%	-0.45%	**4.12%**
Corporate Bonds	6.83%	-0.25%	0.00%	**6.58%**
Municipal Bonds	2.30%	-0.04%	0.00%	**2.26%**

**Average returns are calculated using historical returns from 1988 through April 2014 for each asset class*
***Taxes assume individual is a CA resident in highest tax bracket 55.7% short term, 36.1% long term*
****US and international equities assume 70% turnover, corporate bonds 10% and munis 5%*
*****US and international equties assume ST/LT 20/80*
******Corporate bonds and munis assume ST/LT 0/100*

The Importance of the Funds or Vehicles You Select

Vehicle	2013 Global Stock Index Performance	Fees	Long Term Tax Drag	Short Term Tax Drag	After Tax and Fee Return
ETF	22.35%	-0.21%	0.00%	0.00%	**22.14%**
Mutual Fund	22.35%	-1.39%	-2.58%	-1.00%	**17.38%**
Separately Managed Account	22.35%	-1.00%	-2.42%	-2.49%	**16.44%**
Hedge Fund	22.35%	-2.00%	-0.56%	-7.84%	**11.94%**

**2013 performance taken from MSCI ACWI index*

***Mutual fund assumes 40% turnover, SMA 50%, hedge fund 70%*

****Mutual fund assumes ST/LT 20/80*

*****SMA assumes ST/LT 40/60*

******Hedge fund assumes ST/LT 90/10*

*******Taxes assume individual is a CA resident in highest tax bracket 55.7% short term, 36.1% long term*

********Assumes annual fees for ETF's 0.21%, Mutual funds 1.39%, SMAs 1% and hedge funds 2%*

Not only does asset allocation have a large impact on after tax investment performance, but so does the actual investment vehicle itself. Exchange Traded Funds (ETFs) have gained popularity over mutual funds in recent years partially due to their more tax efficient structure. Mutual funds often generate upwards of 3% in phantom capital gains taxes each year. This also occurs with separately managed accounts (SMAs) and hedge funds which often have very high turnover, thus generating hefty capital gains tax bills. When the higher fees of mutual funds, hedge funds, and SMAs are taken into account, one can see why so many tax sensitive investors are utilizing ETFs in their portfolios. In the chart below, we compared the after fee and after tax return of a global stock ETF, mutual fund, SMA and hedge fund. Using the same assumed gross return for each vehicle (the 2013 MSCI All Country World Index return), you can see how significant the fee and tax drag is on total performance. Our research unveiled that owners of mutual funds, SMAs and hedge funds could be sacrificing 11+% of performance due to fees and taxes.

Security Location and Timing Make a Difference

The type of account in which assets are held can also have a significant impact on overall returns. High growth stocks and funds should be placed in tax efficient retirement accounts where they can grow tax deferred. In addition, tax loss harvesting, that is, selling securities at a loss to offset capital gains, can be an effective way of lowering your tax burden. Here are some easy and effective well known methods to lower your 2014 tax bill.

- **Individual Retirement Account (IRA)** – Most individuals have IRAs that they regularly contribute to year after year. The contribution then can be written off against any other income. For 2013/2014 the maximum IRA contribution is $5,500 for both Roth (no deduction allowed) and Traditional IRAs. The catch up contribution for those over 50 years old is $6,500.

- **Simplified Employee Pension (SEP)** – A SEP is a retirement plan set up by employers including self-employed individuals in order to reduce tax bills. For 2013, up to 25% of income may be contributed to a SEP, up to a maximum of $51,000. For 2014 the maximum amount is $52,000.

- **401K** – These retirement accounts are offered by many employers and can be a great way to reduce taxable income. Often employers match employee contributions - max contribution for 2013/2014 is $17,500 and $23,000 if over age 50.

- **Charitable Contributions** – These contributions have long been a popular method among high income earners to drastically lower tax bills. Individuals may deduct up to 50% of Adjusted Gross Income as a charitable contribution, with no cap on the total amount.

Alternative Tax Saving Methods - For Both Income Tax Planning and Estate Tax Planning

Below we have discussed some lesser known, more advanced tax planning methods to lower taxes either now on your current income or in the future on your estate.

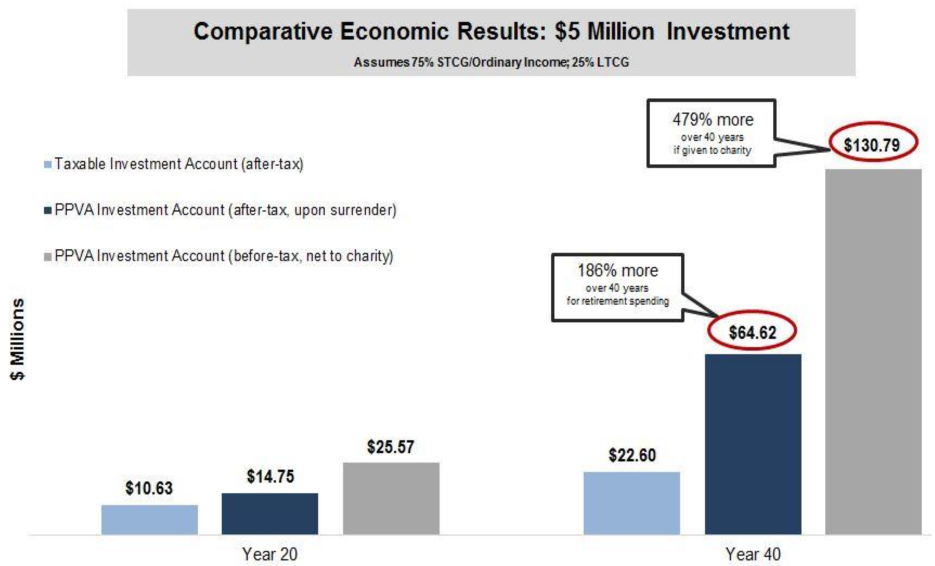
- **Charitable Remainder Trust (CRT) -** A Charitable Remainder Trust (CRT) is a type of irrevocable trust that provides an income interest to a non-charitable beneficiary and a remainder interest to a charitable beneficiary. By creating a CRT, you are given an instant charitable tax discount. This is a very effective method to move assets out of ones estate as well as to reduce income tax liabilities.

- **Family Limited Partnership (FLP) -** A family limited partnership is a legal entity most often formed to manage family wealth and serve as an effective estate tax reduction strategy. The assets placed into the partnership can be discounted and lead to greater tax savings at the time of wealth transfer.

- **Grantor Retained Annuity Trust (GRAT) -** A GRAT is set up through a donation into a trust. The trust is constructed as an annuity, where the donor receives an annual payment from the trust for a fixed period of time. The assets transferred into the trust appreciate in value, and the donor bears the taxes of the appreciation. At the end of the term, the value of the trust minus interest and initial principal is transferred to the beneficiaries. This is a useful technique to freeze one's estate value given the high 40% estate tax rate.

- **Insurance Dedicated Fund (IDF) -** This is private placement insurance that can be in the form or an annuity (PPVA) or a life insurance policy (PPVUL). The IDF offers superior tax efficiency, bulletproof asset protection, and investment flexibility to use various strategies and/or investment vehicles. An IDF allows an individual complete autonomy over their investment allocation. The assets within an IDF grow tax deferred until withdrawal, at which point one will pay ordinary income taxes on the gains. There are no surrender charges or commissions that traditional annuity or insurance products have.

Case Study: Private Placement Variable Annuity



So do all these advanced and seemingly complicated tax saving techniques actually work and save investors substantial sums of money?

Let's examine what would happen if someone invested $5 million in an IDF in the form of a Private Placement Variable Annuity (PPVA). This is a tax deferred, fully diversified portfolio with low fees (typically only about 65-80 bps). After 40 years, the $5 million investment in a PPVA will grow tax deferred to over $64.6 million where**as** the equivalent taxable account will grow to only $22.6 million. The impact of compounding yields an astronomical difference of 186%. These figures are based on a net return assumption of 9.3%.

What You Make versus What You Keep

Success of a portfolio should not be measured in pure performance numbers. Tax laws are endlessly fluctuating but one principle remains constant: we all want to minimize our tax bill. Savvy tax planning can play a vital role in one's wealth management strategy. With the techniques outlined above, a family can potentially save millions of dollars in taxes over the course of their lifetime. Proper asset allocation combined with tax efficient investment vehicles is crucial to reducing your tax burden. It is never too early to begin planning. Talk to your tax or wealth advisor today to see what you can do to ease your tax burden today and well into the future.