The Bernstein Income Tax Playbook

AB BERNSTEIN
Global Wealth Management

Table of Contents

The Bernstein Income Tax Playbook

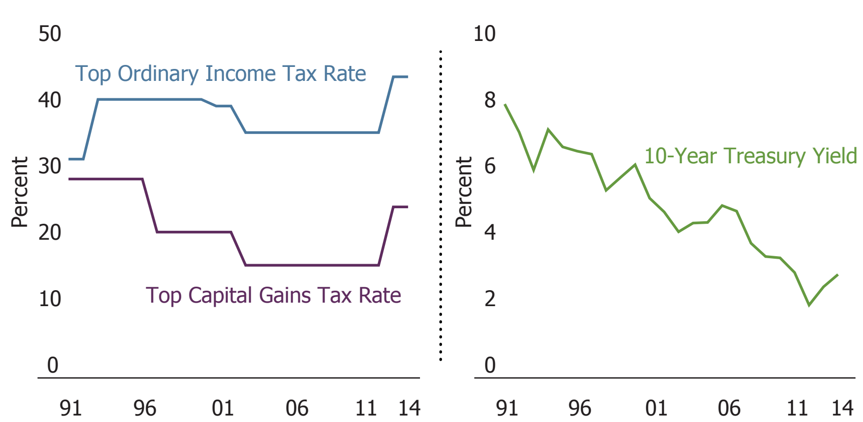
Today's Tax Challenge

It is well known that taxes began to take a bigger bite out of income for the well-off in 2013. Top marginal tax rates rose, as the *display below* shows, and some exemptions and deductions were phased out.

What is less well known is that investors spending from their portfolios—even those investors whose tax rates didn't rise—may be facing higher tax bills, too. Historically low interest rates continue to depress the tax-exempt income from municipal bonds, so many investors spending from their portfolios have to sell assets to replace lost income. Given the stock market's terrific gains over the past five years, selling stocks generally means realizing taxable capital gains, and most investors have few or no tax-loss carryforwards left from 2008 to offset those gains.

We therefore think that smart tax management is more important than ever. This playbook includes a range of actionable strategies that can help you realize better after-tax outcomes in today's challenging environment.

Tax Rates Are Up and Bond Yields Remain Low



Through March 31, 2014
Source: Internal Revenue Service (IRS), Treasury and AllianceBernstein

Table of Contents

What Can Investors Do?

This playbook explains a number of strategies for avoiding and deferring taxes that investors and their tax advisors can consider. Some are relatively simple, such as making a charitable gift or maximizing retirement savings. Others are more complex to evaluate, such as converting an individual retirement account (IRA) to a Roth IRA, or establishing a charitable remainder unitrust (CRUT).

In each case, we discuss how the strategy works, whom it's likely to help most, what kind of benefit it provides, and its drawbacks, risks, limitations and tax impact.

We also quantify the potential benefit, using our Wealth Forecasting System, which takes into account both tax considerations and our projections of 10,000 plausible scenarios for future capital-market returns. Sometimes, we show the median likely outcome; other times, the range of likely outcomes. (See "Wealth Forecasting," page 12, and "Notes on Wealth Forecasting System," page 40.)

Some of these strategies are governed by complex tax rules; the discussions herein may not touch on every aspect relevant to your situation. Check with your tax advisor before adopting these strategies.

Animating Principles

We elaborate on some of the key issues that investors should address in "The Investment Life Cycle and Taxes," page 3, and "Investing for Tax-Efficient Income," page 9. But broadly speaking, our approach rests on a few key principles:

Don't let the tax tail wag the investment dog. Maximizing after-tax investment returns within the investor's risk and return objectives should be the goal, not minimizing taxes per se. After all, the best way to minimize taxes is to have no income. Investors who invest their entire portfolio in tax-exempt bonds may pay no tax on their investments, but they are unlikely to obtain the long-term growth they need.

Avoiding tax is permanent; deferring tax just kicks the tax can down the road—possibly to a time when tax rates may be higher. Tax-loss harvesting, while often beneficial, just defers tax to a future year. Sometimes, the transaction costs or bid-ask spreads may eat up most or all of the benefit (page 7).

Tax laws change, although not as often as it may seem. It may be prudent not to rely too much on any tax-related strategy. Roth conversions (page 23) and charitable remainder unitrusts (page 37) are among the strategies with legislative risk.

Maintaining liquidity is important. Paying tax up front in a Roth IRA conversion or front-loading gifts to a 529 account (page 13) may maximize after-tax wealth, but both strategies may leave an investor without easy access to needed funds.

Costs matter, too. Some tax-related strategies, such as a charitable remainder unitrust, require up-front or ongoing legal and accounting fees; they are generally most economical when applied to large amounts (page 37). Similarly, private foundations may maximize control over philanthropic gifts, but they are generally economical only for very large charitable programs (page 33). And today, high guarantee fees make some variable annuities unattractive (page 27).

Different taxes may require different strategies. This playbook focuses primarily on strategies that address federal *income* taxes. Other taxes, including federal gift, estate and generation-skipping transfer taxes, and many types of state and local taxes, can present related or entirely distinct hurdles for investors.

Every taxpayer's goals and circumstances are different. The state you live in, the number of dependents you have, and your tax bracket, total wealth, embedded gains and losses, and time horizon will determine whether these strategies are likely to work for you. We suggest that you use this playbook to identify strategies that you and your tax advisors can explore in greater detail.

Bernstein can help you to quantify the potential benefits for you, to design and manage a particular strategy, or both. Working with clients and their tax advisors is central to the service that Bernstein offers.

Bernstein does not offer tax, legal or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decision.

The Investment Life Cycle and Taxes

You invest to grow your wealth, but what are you growing it for? There can only be two reasons: You need to spend it during your lifetime, or you want to give it away to causes or people you care about.

Either goal must overcome a common hurdle: taxes. Often, investors focus on tax strategies from year to year without taking a step back to look at the big picture. How you save or spend money today can have a profound impact on your after-tax wealth over the long term and, ultimately, on your legacy.

During the working years when most investors accumulate wealth, you should generally emphasize investing in assets, such as stocks, that tend to grow in value, and make smaller allocations to risk-mitigating assets, such as bonds. But growth alone does not guarantee long-term success. If you do not invest in a tax-aware manner, federal, state and local taxes may eat up more than half of your investment return. It's what you keep, not what you make, that matters. Recognizing that can help build wealth for future goals.

Your asset allocation may become less growth-oriented when you retire, but tax-efficient sources of capital remain important both in retirement and when you leave assets to charity or loved ones.

Over the course of a lifetime, the control that you can exert over your

Tax Efficiency Changes over the Course of Your Life

Tax Efficiency	*Working/Saving Years*	*Retirement/Spending Years*	*Legacy*
Higher	Employer-sponsored plans Pretax IRA Roth IRA 529 plan Charitable contributions Timing trades to avoid taxes	Portfolio income High-basis stocks Low-basis stocks Charitable contributions Timing trades to avoid taxes	IRA to charity Appreciated property Low-basis stocks Roth IRA
Lower	Loss harvesting After-tax IRA Variable annuities	Loss harvesting IRAs Roth IRAs	High-basis stocks Cash IRA
No Control	Timing and taxes on cash compensation	Required minimum distributions	

Source: AllianceBernstein

sources of income and taxes will vary, as the *display on the prior page* illustrates. The display also ranks the tax efficiency of various strategies.

The Working and Saving Years

If you are still working and saving, you probably have relatively little control over when to recognize income. If most of your income comes from cash compensation, and that compensation is the only source of the money you spend, you will have few opportunities to control the size of your tax bill.

But you can prioritize saving money in ways that lower your tax bill today and for years to come. Saving through a qualified retirement plan allows you to defer taxable income today into your retirement years, when you may be in a lower tax bracket. You can also save for your children's or grandchildren's educations on a tax-free basis through a 529 plan; give to charity to avoid tax today; and manage your portfolio in a tax-aware manner.

The Retirement Years

In retirement, you can also prioritize *spending* in ways that minimize your overall tax bill.

Because you can't control it, a required minimum distribution (RMD) from an IRA is often the first source of an investor's retirement spending, along with Social Security. The RMD is taxed at ordinary tax rates.

If you don't need the entire RMD to support your lifestyle, you may want to consider converting a portion of your IRA to a Roth IRA. Although you would have to pay some tax up front, this could significantly reduce your annual tax bill going forward and increase your legacy.

If you need more than the RMD and Social Security to support your lifestyle, it is generally most tax-efficient to withdraw additional funds from your taxable portfolio rather than from your retirement portfolio. Funding your additional spending from a taxable account allows you to manage the taxable capital gains you recognize. It's generally a good idea to sell stocks with a high cost basis (limited capital gains) before selling stocks with a low cost basis (substantial capital gains). Harvesting losses may help offset some of the gains you recognize.

Sourcing spending dollars in these ways can keep your overall tax bill relatively low and allow your remaining retirement-plan assets to continue to grow on a tax-deferred basis.

Your Legacy

You can maximize the assets you leave as a legacy by paying careful attention to the intersection of estate and income taxes. Under current law, each person can leave up to $5.34 million to non-charitable, non-spouse beneficiaries free of federal estate tax. (There is no limit on transfers to charity or spouses who are US citizens.) In addition, most types of assets receive a "step-up" in cost basis at death, erasing any embedded capital gain.

Highly appreciated property that will receive a step-up at death is generally a good candidate for your legacy, and it should generally be among the last sources for spending, so that you can avoid significant tax on capital gains. Certain kinds of appreciated property, like collectibles, are subject to higher tax than the typical long-term capital gain on stocks. Thus, those assets should be the last you sell to fund lifetime spending.

There is no step-up in cost basis for retirement accounts, so it's most efficient to leave a tax-deferred IRA to a charity that will never pay tax (as your taxable beneficiaries would). If you leave a tax-free Roth account to loved ones, they can stretch the nontaxable payments over their expected life span.

The intersection of the estate and income tax regimes needs thoughtful and nimble management. The rules may change over time. These are matters to discuss carefully with your tax advisors. Bernstein may be able to help you and your tax advisors quantify the benefits and risks of the various strategies you consider.

Portfolio Strategies

Avoiding Short-Term Gains

Best for:	Anyone
Benefit:	Tax avoidance
Tax Impact:	
Limitations:	Must meet IRS holding requirements for long-term gains or qualified dividend treatment
Complexity/Cost:	Minimal
Drawbacks:	Risk of continuing to hold investment

Investors can reduce taxes on investment income by being diligent about timing transactions to take advantage of favorable rates. Capital gains on the sale of stocks held for more than a year are taxed at a lower, long-term capital gains rate than gains on the sale of stocks held a year or less. (See the tax-rate table, page 6.)

Dividends from both common and preferred stock in qualified corporations are also taxed at the lower long-term capital gains rates, if the taxpayer meets certain holding requirements.

Timing transactions may sound easy, but it can be complicated, particularly for investors with large, diversified portfolios divided among multiple accounts. Bernstein integrates efficient tax management into the investment management of our taxable portfolios.

How It Works

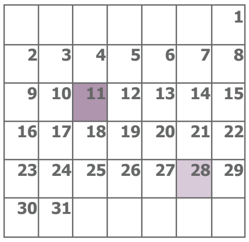
For a position to be considered long term, it must be held for more than one year. By waiting to sell a position at a gain until it has been held for more than a year, a top-bracket taxpayer can reduce the tax bite substantially—from 43.4% to 23.8%. Investors in lower tax brackets can sometimes entirely eliminate the capital gains tax by waiting.

Quantifying the Benefit

The *display below* quantifies the benefit of waiting to sell—even if the value of the stock falls in the interim. In this example, an investor purchased Facebook stock for $25 per share on March 27, 2013. Almost a year later, the investor held the stock at a gain: Facebook hit its 52-week high on March 11, 2014. The investor was tempted to sell, but there were still more than two weeks to go until the gains realized on the holding would become subject to long-term, rather than short-term, capital gains tax. If the investor sold at the high, she would realize a sale price of

Timing Trades to Avoid Taxes

Purchased Facebook 3/27/2013: $25.00 per Share



Sell Facebook Shares	52-Week High 3/11/2014	Long-Term Gain 3/28/2014
Cost basis	$25.00	$25.00
Sale price	72.59	61.34
Short-term gain	47.59	—
Long-term gain	—	36.34
Tax rate	43.4%	23.8%
Tax cost	**$20.65**	**$8.65**
Net proceeds	**$51.94**	**$52.69**

Even with Facebook's price falling more than 15%, a high-tax-rate investor is better off waiting for long-term-gain treatment.

Source: AllianceBernstein; see Disclosure on Security Examples, page 41.

$72.59 but would owe 43.4% tax on a $47.59 short-term gain. A tax bill of over $20 would net her only $51.94 per share.

By continuing to hold the stock, the investor would risk losing some of the embedded gain but could gain much more favorable tax treatment. Even if the stock dropped 15%, she would garner greater after-tax proceeds by waiting for the stock to go long term than by selling at the high.

Assuming that the investor sold the position at the opening price on the day it went long term, March 28, 2014, she would realize a sale price of $61.34, about $11 below the high. But by reducing her tax to the long-term capital gains tax rate, she would net $52.69, or 1.4% more.

Of course, the opposite could have occurred. The position could have increased in value while she held the stock for long-term-gain treatment, so that she could have saved in taxes *and* earned a higher gross return.

As the Facebook example shows, it's not what you receive that matters, but what you get to keep.

Dividend Considerations

For dividends, it's important to pay attention to the ex-dividend date: the first date following the declaration of a dividend on which the buyer is not entitled to receive the next dividend payment. Instead, the seller gets it.

For a dividend to be qualified, an investor must hold the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date. In other words, if an investor buys a position the day before the ex-dividend date, she will receive the dividend but will need to continue to hold the position for 60 days in order to receive qualified dividend tax treatment. (When counting the number of days, she can count the day she sells the stock but not the day she acquires it.)

For certain preferred stocks that pay dividends less than once a year, the holding period is increased to 90 days during the 181-day period beginning 90 days before the ex-dividend date.

Current Income Tax Rates

Single Filer Income	Joint Filer Income	Income Tax Rate	Short-Term Capital Gains and Investment Income Tax Rate*	Long-Term Capital Gains and Qualified Dividend Tax Rate*
$0 to $9,075	$0 to $18,150	10.0%	10.0%	0.0%
$9,076 to $36,900	$18,151 to $73,800	15.0	15.0	0.0
$36,901 to $89,350	$73,801 to $148,850	25.0	25.0	15.0
$89,351 to $186,350	$148,851 to $226,850	28.0	28.0	15.0
$186,351 to $200,000	$226,851 to $250,000	33.0	33.0	15.0
$200,001 to $405,100	$250,001 to $405,100	33.0	36.8	18.8
$405,101 to $406,750	$405,101 to $457,600	35.0	38.8	18.8
$406,751+	$457,601+	39.6	43.4	23.8

**Includes surtax on net investment income*
Pease limitation on itemized deductions and personal exemption phaseout begins at $254,200 for single filers or $305,050 for joint filers.
Source: IRS and AllianceBernstein

Portfolio Strategies

Loss Harvesting

Best for:	Anyone
Benefit:	Primarily tax deferral; tax avoidance at times
Tax Impact:	
Limitations:	"Wash sale" rule
Complexity/Cost:	Minimal; transaction costs
Drawbacks:	Only defers gains into future years

With the stock market near an all-time high, most investors will realize gains when they buy and sell stocks to manage their portfolios, rebalance their asset allocation, or withdraw funds for spending. Loss harvesting can help minimize the tax impact of realizing gains in the current year.

How It Works

To harvest a loss, an investor sells a security that has fallen below its purchase price (or cost basis), in order to offset a gain booked elsewhere in the portfolio, as the *display at right* shows.

Let's suppose that an investor sold Stock A at a gain of $50, and wants to offset that gain. The investor also holds Stock B, with a cost basis of $100 and a current value of only $50. He can sell Stock B today for $50 and generate a $50 loss. The investor could then reinvest the $50 proceeds in something else or, if he still believes in Stock B's potential, he can repurchase it after 31 days to avoid a wash sale, as explained on page 8.

If the investor repurchases Stock B 31 days later for the same $50 sale price, the investor's basis in Stock B goes from $100 to $50. In effect, the investor has "borrowed" some of the original cost basis of Stock B to offset the gain realized on Stock A.

But using losses to offset gains only defers gains; it does not avoid them. If, at some future date, the investor sells Stock B, the capital gain recognized will be that much larger, assuming that the stock eventually recovers.

Loss Harvesting Defers—but Does Not Avoid—Taxes

Harvesting a $50 loss and repurchasing the stock
Combined federal and state long-term capital gains tax rate of 25%

Stock A: Recognized Gain	This Year ($)	Next Year ($)
Existing gain	50.00	—
Potential long-term capital gains tax	12.50	—
Stock B: Harvested Loss		
Cost basis	100.00	50.00
Sale price	50.00	100.00
Repurchase price (new cost basis)	50.00	—
Long-term gain (loss)	(50.00)	50.00
Tax deferred	**12.50**	0.00
Tax paid	0.00	**12.50**

Data are for illustrative purposes only. We use round numbers to demonstrate how cost basis changes when losses are harvested. There is no expectation that a typical stock would double in price over one year.

Source: AllianceBernstein

Quantifying the Benefit

Deferring taxes through effective loss harvesting allows a portfolio to grow a bit more. For an investor with a combined federal and state capital-gains tax rate of 25%, deferring the $50 gain on Stock A will put off the $12.50 tax bill to a future date and keep $12.50 in the portfolio (see *display on prior page*).

If the investor keeps the money in the portfolio for more than a year and earns 10% on it, he will have a $1.25 return. Of course, that return is taxable when the gain is realized (again, at 25%), so the after-tax return from the trade will be $0.94.

In other words, the investor has sold and repurchased a stock worth $50—a total trade value of $100—to earn $0.94.

When the benefit is so small, transaction costs must be taken into account. Even if an investor does not pay trading commissions, there are costs related to the difference between purchase and sale prices (bid-ask spreads). In the Facebook example on page 5, the trade would *erode* value, not add to it, if the costs on the purchase and sale were greater than 1%.

Realizing losses can be more valuable in some circumstances. Investors can use realized net losses of up to $3,000 as an above-the-line deduction against ordinary income to *avoid* (not defer) taxes. For investors in the top tax bracket, that can be worth over $1,000 in current-year tax savings. But in periods like the present, when strong markets have created sizable portfolio gains, few investors have net loss positions.

The Wash Sale Rules

To ensure that a loss can be recognized for tax purposes, taxpayers need to follow the "wash sale" rules: If an investor sells a position at a loss and buys the same, or substantially the same, security within 30 days before or after the sale closes, he cannot recognize the loss until he sells the replacement security.

To avoid falling afoul of the wash sale rules, it often makes sense to sell a position at a loss and replace it with a similar security, such as a stock in another company in the same industry or sector. This minimizes the disruption to the portfolio and potential loss of market upside.

The wash sale rules apply even if the replacement security is in the investor's IRA. Thus, taxpayers and their advisors have to tax manage a portfolio across *all* accounts. This can be difficult to do if there are different managers for various portfolios, because typically, the managers will not have current information on each other's holdings.

This makes integrated investment management beneficial from a tax perspective. Bernstein tax manages across all the accounts that we run for a client.

Portfolio Strategies

Investing for Tax-Efficient Income

Best for:	Income-oriented investors spending from their portfolios
Benefit:	Tax deferral and avoidance
Tax Impact:	
Limitations:	None
Complexity/Cost:	Low
Drawbacks:	Sacrifices future growth or increases risk

With tax-exempt income from municipal bond portfolios still near historic lows, investors spending from their portfolios have become desperate for income. As a result, many investors today are chasing yield into dangerous territory.

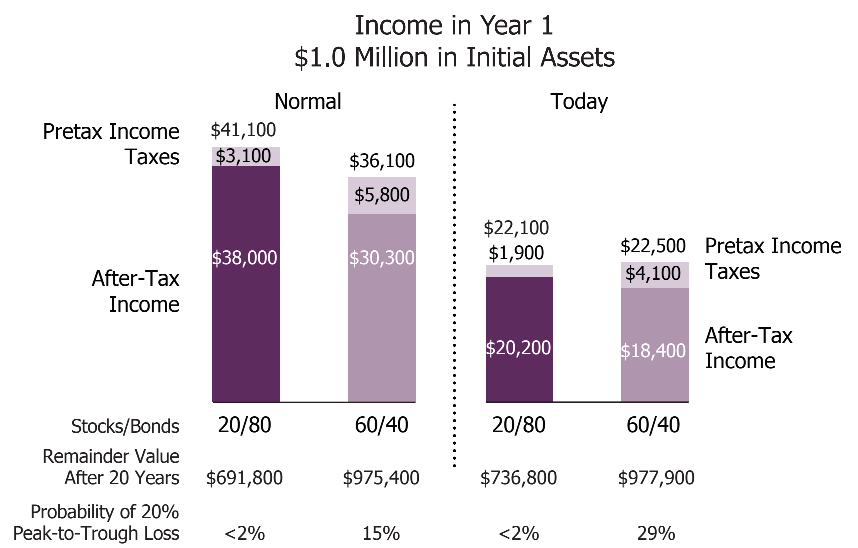
Typically, yield-hungry investors shift to longer-duration bonds or to lower-credit-quality (high-yield) bonds, or both. Such investments may merit an allocation, but many investors do not adequately weigh the likely consequences.

We think that investors seeking tax-efficient income should weigh three considerations: after-tax income, tax-efficient growth, and risk. Below, we evaluate the trade-offs for several potential solutions.

Why the Traditional Solution Isn't Working

Under normal market conditions, a bond-heavy allocation makes sense for many income-oriented investors, in our analysis. Normally, a $1 million portfolio with a 20/80 stock/bond mix would generate more income than a $1 million portfolio with a 60/40 stock/bond mix, as the *display below* shows. And since most of the income of the 20/80 portfolio would come from tax-exempt bonds, the gain in after-tax income would be even larger: almost $8,000 for someone in today's top tax bracket. (See "Wealth Forecasting," page 12.)

Income Is Now Scarce



Remainder value is in real dollars. Equities comprise 21% US value, 21% US growth, 21% US diversified, 7% US small-/mid-cap, 22.5% developed international and 7.5% emerging markets; bonds are intermediate-term diversified municipal bonds. Assumes top federal tax rates and a 6.5% state income tax rate.

Projections indicate the probability of a peak-to-trough decline in pretax, pre-cash-flow cumulative returns of 20% over the next 20 years. Because the Wealth Forecasting System uses annual capital-market returns, the probability of peak-to-trough losses measured on a more frequent basis (such as daily or monthly) may be understated. The probabilities depicted above include an upward adjustment intended to account for the incidence of peak-to-trough losses that do not last an exact number of years. Based on Bernstein's estimates of the range of returns for the applicable capital markets over the periods analyzed. See Notes on Wealth Forecasting System for details. ***Data do not represent past performance and are not a promise of actual future results or a range of future results.***

Source: AllianceBernstein

But market conditions today are far from normal. As the *display on the prior page* also shows, the pretax income from a 20/80 portfolio today is far lower than normal: $22,100 versus $41,100. And with dividend yields higher than bond yields today, shifting to a 60/40 portfolio would actually *add* modestly to pretax income.

But for taxable investors, it's after-tax income that matters. Because most of the income comes from tax-free bonds, today the 20/80 portfolio provides more after-tax income than the 60/40 portfolio, but only about $2,000 more, versus nearly $8,000 under normal conditions.

After 20 years of spending all the income the portfolio generates but not selling any securities, the median inflation-adjusted value of $1 million invested in a 20/80 portfolio is likely to be just $736,800, we estimate. For a 60/40 portfolio, by contrast, the median value would be $977,900.

In our experience, few investors would choose a portfolio that provides less than $2,000 a year in additional after-tax income, if they understood that it would reduce their wealth after 20 years by about $240,000.

Quantifying the Benefits and Risks of Popular Solutions

That's why many income-seeking investors are now choosing a 60/40 stock/bond allocation but replacing their core, high-credit-quality, intermediate-duration bond portfolio with allocations to high-yield or longer-duration bonds, or both. The income gains from such shifts are substantial on both a pretax and after-tax basis.

The *display on the next page* shows that investors can increase the after-tax annual income on the $1 million portfolio by $8,500 if they shift their 40% bond allocation from core fixed income to long-term, high-quality bonds. They could gain more than $21,000 of additional income if they shift it all to high-yield bonds, and about $15,000 more if they shift it to an equal mix of the two.

But the magnitude of the risk that these three popular income strategies add is not well understood. Today, an investor in a 60/40 portfolio faces a 29% chance of incurring a 20% peak-to-trough loss at some point over the next 20 years, we estimate. Shifting the bond allocation to long bonds would increase the risk of a large loss to 39% because long bonds lose more value than intermediate-term bonds when interest rates rise.

The risk of a large loss rises to 55% for the 60/40 portfolio with high-yield bonds and to 47% for the 60/40 portfolio with an equal mix of high-yield and long-term bonds.

Because of their greater volatility, using these three popular income strategies is likely to lead to less wealth over time than using a core bond portfolio. For example, we project that the 60/40 portfolio with high-yield bonds, which generates the most income, would lead to a give-up in future wealth similar to a 20/80 portfolio, in the median case, as the display shows.

In our experience, the risks that each of these three popular strategies poses are too high for most income-oriented investors.

Quantifying the Benefits and Risks of Lower-Risk Solutions

Fortunately, it's possible to garner more income without adding as much risk. The key is to source the higher-income, but higher-risk, investments from the stock allocation of the portfolio, rather than the bond allocation. You can see this in the three potential lower-risk variations on a 60/40 portfolio in the *display on the next page*.

The first lower-risk variation replaces the broad US large-cap stock portion of the 60/40 portfolio with similar stocks with higher dividend yields. This increases the after-tax income of the portfolio by less than $1,300—even less than shifting to a 20/80 stock/bond mix. It also decreases the projected future value of the portfolio much less than shifting to a 20/80 portfolio.

But the tilt to higher dividends reduces the risk of a large loss from 29% to 25%, because higher-dividend-yielding stocks are typically less volatile, while offering moderately lower growth than the broad market.

The second lower-risk variation on a 60/40 mix adds a 10% allocation to high-yield municipal bonds, sourced from stocks, rather than from bonds. This variation increases the portfolio's after-tax income to $24,100, nearly $6,000 more than the original 60/40 allocation, and also reduces the probability of a large loss substantially—from 29% to 19%. While high-yield bonds are more volatile than investment-grade bonds, they are less volatile than stocks.

The downside is that this lower-risk portfolio is likely to be worth less after 20 years, in the median case, because high-yield bonds tend to generate much less growth than stocks do.

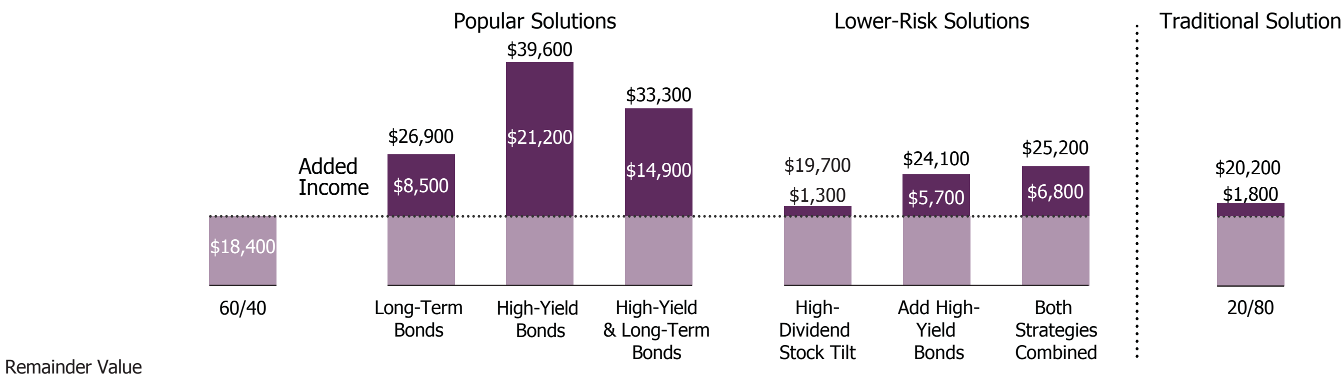
The third lower-risk variation combines the first two. This variation increases the portfolio's after-tax income the most, to $25,200, nearly $7,000 above the original 60/40 allocation. It also reduces the projected value of the portfolio after 20 years the most, to $849,000.

However, the investor gets a lot less risk: The probability of a 20% peak-to-trough loss falls to just 16%, close to the 15% probability of a large loss that a 60/40 portfolio offers under normal market conditions.

In our experience, the three lower-risk solutions are likely to fit the risk tolerance of most income-oriented investors better than the three popular solutions.

High-Income Solutions Vary Widely: After-Tax Income, Risk and Long-Term Wealth

After-Tax Income in Year 1
$1.0 Million in Initial Assets



	60/40	Long-Term Bonds	High-Yield Bonds	High-Yield & Long-Term Bonds	High-Dividend Stock Tilt	Add High-Yield Bonds	Both Strategies Combined	20/80
Remainder Value After 20 Years	$977,900	$885,600	$736,800	$812,100	$965,000	$862,000	$849,000	$736,800
Probability of 20% Peak-to-Trough Loss	29%	39%	55%	47%	25%	19%	16%	<2%

"60/40" assumes 60% invested in global equities and 40% invested in intermediate-term diversified municipal bonds. "Long-Term Bonds" assumes 60% in global equities and 40% invested in long-term diversified municipal bonds. "High-Yield Bonds" assumes 60% invested in global equities and 40% invested in high-yield municipal bonds. "High-Yield & Long-Term Bonds" assumes 60% invested in global equities, 20% invested in high-yield municipal bonds and 20% invested in long-term bonds. "High-Dividend Stock Tilt" assumes 37.8% US value, 4.2% US SMID, 13.5% developed international, 4.5% emerging markets and 40% intermediate-term diversified municipal bonds. "Add High-Yield Bonds" assumes 50% global equities, 10% high-yield municipal bonds and 40% intermediate-term diversified municipal bonds. "Both Strategies Combined" assumes 31.5% US value, 3.5% US SMID, 11.25% developed international, 3.75% emerging markets, 10% high-yield municipal bonds and 40% intermediate-term diversified municipal bonds.

Remainder value in real dollars. Projections indicate the probability of a peak-to-trough decline in pretax, pre-cash-flow cumulative returns of 20% over the next 20 years. Because the Wealth Forecasting System uses annual capital-market returns, the probability of peak-to-trough losses measured on a more frequent basis (such as daily or monthly) may be understated. The probabilities depicted above include an upward adjustment intended to account for the incidence of peak-to-trough losses that do not last an exact number of years. Based on Bernstein's estimates of the range of returns for the applicable capital markets over the periods analyzed. See Notes on Wealth Forecasting System for details. ***Data do not represent past performance and are not a promise of actual future results or a range of future results.***

Source: AllianceBernstein

Wealth Forecasting: A Key Element in Evaluating Strategies

Investment and tax decisions can have very long-term ramifications. Retirement plans may involve 40 or more years of saving—and another 30 to 40 years of spending. Education plans typically cover 18 years of saving and at least four years of spending.

To make prudent decisions about the distant future, investors need a crystal ball or, next best, a way to estimate the long-term results of potential strategies. Bernstein uses its Wealth Forecasting System[SM] to make such estimates (see *display*).

We start each analysis with the investor's profile and then build scenarios around the decisions that the investor is weighing. Then, we use our Capital Markets Engine (CME) to project the range of likely outcomes.

Our CME takes account of the linkages within and among the capital markets, as well as their unpredictability. Our return forecasts derive from observable historical patterns in financial metrics, asset-specific factors, and the potential impact of inflation, deflation and taxes.

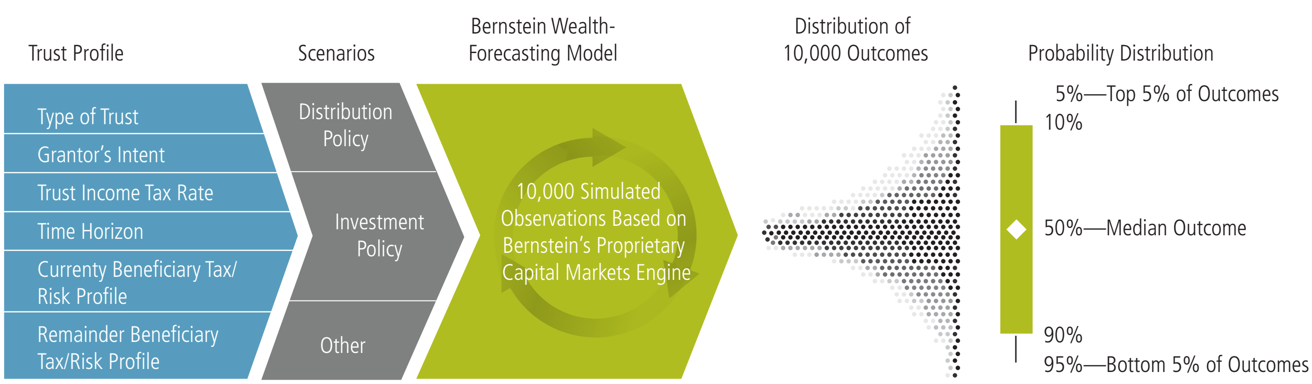
Starting from today's conditions, we simulate 10,000 plausible paths for inflation and a wide range of returns on investment assets. If 9,000 of these 10,000 trials achieve or exceed a result, the outcome is attainable even if market returns are poor. We call this the 90% level of confidence. We also focus on the 50% level of confidence—the median result—and the 10% level of confidence—the outcome when market conditions are very good.

As shown in this playbook, our analysis gives investors and their tax advisors a read on whether a given decision about investments, distributions or tax strategy is likely to achieve the intended result.

We also use the CME to determine "normal" asset-class returns. We define "normal" as an environment in which all asset classes are fairly priced and in equilibrium with one another. Typically, it is close to a very long-term historical average. Our estimates of normal returns begin with an efficient-market perspective.

Our methodology does not supply answers. It provides perspective on probable outcomes, enabling investors to make well-informed decisions about various strategies.

Estimating Potential Outcomes: Bernstein's Wealth Forecasting System[SM]



- Based on the current capital-market environment
- Incorporates various accoutn types and planning vehicles
- Predictes likelihood of meeting long-term goal

See Notes on Wealth Forecasting System on page 40 for details.

Source: AllianceBernstein

Education Savings

Best for:	Parents and grandparents saving for higher education
Benefit:	Tax avoidance
Tax Impact:	
Limitations:	Contributions are considered gifts; see below
Complexity/Cost:	Minimal
Drawbacks:	10% tax penalty on earnings not used for education

Saving for a child's or grandchild's college or graduate school tuition is in some ways a more daunting challenge than saving for retirement: The costs are impossible to control, and the time you have to save is shorter—typically, just 18 years.

Fortunately, there is a tax-advantaged way to save: a Section 529 plan. Contributions to the plan grow free of federal tax, and earnings can be withdrawn tax free as long as the funds are used for "qualified higher-education expenses." These include tuition, fees, books, supplies and equipment, and special-needs services required for enrollment or attendance at an eligible educational institution, as well as room and board, for students attending at least half time.

Another program, called a Coverdell Education Savings Account, is also available, but only to couples with less than $220,000 and individuals with less than $110,000 in annual income. It has much lower contribution limits.

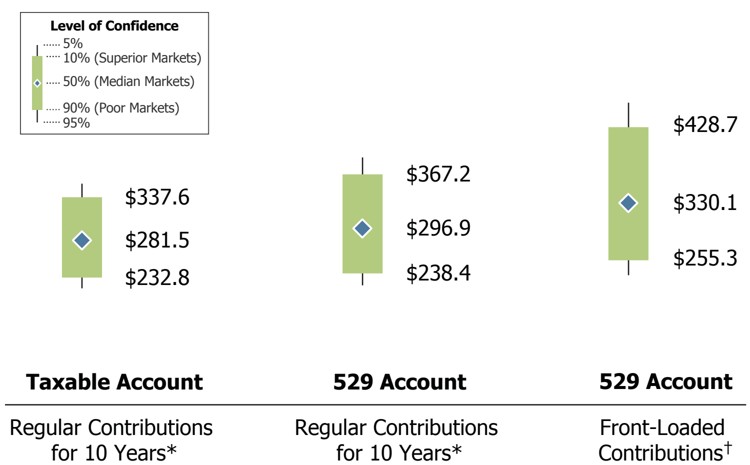
How a 529 Plan Works

Contributions to a 529 plan for a child beneficiary are considered gifts, but qualify for the gift-tax annual exclusion, which is now $14,000 per beneficiary and increases with inflation. Taxpayers can make gifts of up to $14,000 ($28,000 for a married couple) per year to a 529 account for the benefit of any number of individuals, such as children and grandchildren.

The 529 program allows taxpayers to front-load five years of annual

Funding a 529 Plan Early Results in More Savings

Inflation-Adjusted 529 Plan Assets After 10 Years (in $ Thousands)



**$28,000 per year for 10 years*

†$140,000 in the beginning of year one and $140,000 at the beginning of year six

The assets are invested in 70% globally diversified equities and 30% fixed income when the child is age 8, and become more oriented toward bonds over time, until reaching 25% globally diversified equities and 75% fixed income at the child's college age. Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 10 years. See Notes on Wealth Forecasting System for details. ***Data do not represent past performance and are not a promise of actual future results or a range of future results.***

Source: AllianceBernstein

exclusion gifts, and thus give up to $70,000 in one year ($140,000 for a married couple) per beneficiary.

The option to front-load funding makes the 529 plan a great way to avoid taxes on the future growth of funds earmarked for higher education expenses. Bernstein projects that, in aggregate, the taxes avoided over a 10-year savings horizon could pay for a full year of college tuition.

Quantifying the Benefits

Let's assume that a married couple expects their child, currently in second grade, to start college in 10 years. They have just begun to save for her college tuition and want to look at a few options:

- Save $28,000 per year for the next 10 years in a taxable account;
- Save the same amount in a 529 plan over 10 years; or
- Use $140,000 from a recent bonus to front-load the 529 plan with five years of contributions today and again at the beginning of year six.

These amounts may seem outlandish, but the cost of attending an elite private college is now about $65,000 a year and is rising faster than inflation. The benefits of smaller contributions are scalable.

The *display on the prior page* illustrates the advantage of the 529 plan. The taxes avoided by saving each year in a 529 plan increase the 529 plan's account value to $296,900, or $15,400 more than the $281,500 in the taxable account, in today's dollars in the median case, represented by the diamond within each bar.

When the contributions are front-loaded, the additional years of tax-free growth bring the median value of the 529 plan to $330,100 in today's dollars, or $48,600 more than in the taxable account. To the extent that parents or grandparents begin saving via a 529 plan earlier in a child's life, the tax-free growth potential is even greater.

Many investors fear front-loading their contributions to a 529 plan. What if the market plunges in the first year? they ask. Wouldn't I be better off spreading out the contributions so that I'd be investing at lower prices after a market drop?

The answer is no. Our worst projected outcomes for the 529 account with front-loaded contributions are still higher than the worst projected outcomes for the 529 account with regular contributions for 10 years, the display shows.

Additional Considerations

When considering a front-loaded contribution, think about its timing. Toward the end of the year, it may make more sense for a taxpayer to make an annual exclusion gift for the current year and plan to front-load five years of contributions in January of the next year. That way, more money can begin growing tax free more quickly.

Some taxpayers may worry about overfunding the 529 plan for a child who may not need the funds to pay for college (because he doesn't go to college or gets a scholarship). In the first case, the funds can also be used for certain trade schools. In the second case, the IRS allows taxpayers to withdraw, without the 10% penalty tax, amounts equal to the scholarship.

The beneficiary can also be changed to another family member of the same generation at a later date.

Some states provide a state income tax deduction for contributions to a plan in the taxpayer's home state. A home-state plan is not always the best option. Taxpayers should be mindful of fees associated with the home-state plan and limits on the size of the account.

Retirement Overview

The US government has made the tax code a central tool in its policy of supporting retirement saving for 100 years.

In the early 20th century, it began to designate employer-sponsored pension plans as "qualified" in the new income tax code, if they met certain rules. Participants in qualified plans do not have to pay taxes on the benefits until they receive pension payments. However, qualified plans must provide benefits to most full-time employees, not just those who are highly compensated.

These employer-sponsored plans, designed to attract and retain employees, differ significantly from commercially available deferred annuities, or "non-qualified" plans, that invest after-tax dollars on behalf of the purchaser.

Since the 1970s, Congress has invented a multitude of new types of qualified retirement savings plans, most of them aimed at segments of the population not covered by traditional defined benefit pension plans. Some are widely used, such as IRAs (which are not employer-based). Others are truly niche offerings.

In recent decades, employers have shifted from providing costly defined benefit (DB) retirement plans to offering optional salary-deferral defined contribution (DC) plans, such as a 401(k). In DC plans, the individual, not the employer, has primary responsibility for contributions and investment decisions.

Many employers match part of employee contributions to encourage employees to contribute. But the burden of saving for retirement today rests primarily with the individual, not the employer.

The challenge for individuals is to make the best use of the plans available to them to maximize their retirement savings, while minimizing their current and future taxes.

This section seeks to quantify some of the trade-offs. Our research identified three key conclusions about retirement plans:

- Employer-sponsored plans that include a salary deferral component allow taxpayers to earn investment returns on dollars that would otherwise have been lost to taxes.
- Plans that use after-tax dollars but only defer taxes, such as nondeductible IRAs and variable annuities, should be used with caution.
- Sometimes it makes sense to pay tax now in order to avoid tax later. That's the case with Roth IRAs.

The tables on the next three pages outline the key characteristics of the more widely used types of retirement plans. There is no "best" choice for most individuals. Combining several plans may help maximize your tax benefits, while diversifying the risk of future changes in tax rules.

	Defined Contribution Plans			
	SIMPLE 401(k)	Traditional 401(k)	Roth 401(k)	Profit Sharing & Money Purchase Plans
Key Features	Earnings grow tax deferred Contributions are deductible for employer Contributions reduce employee's taxable income	Earnings grow tax deferred Contributions are deductible for employer Contributions reduce employee's taxable income	Earnings grow tax deferred Contributions are *not* deductible Contributions do *not* reduce employee's taxable income	Earnings grow tax deferred Contributions are deductible for employer Profit-sharing plan contributions are discretionary Money purchase plan contributions are mandatory
Eligibility	Employers with 100 or fewer employees that do not currently maintain another retirement plan Employees must have one year of service and 1,000 hours per year and be at least 21 years old	Employees must have one year of service and 1,000 hours per year and be at least 21 years old	Employees must have one year of service and 1,000 hours per year and be at least 21 years old	Employees must have one year of service and 1,000 hours per year and be at least 21 years old
Contributors	Employee and employer	Employee and employer	Employee only	Employer only
Maximum Contribution	Employees under age 50: the lesser of $12,000 or 100% of pay Employees age 50 and over: the lesser of $14,500 or 100% of pay Employer must match up to 3% of employee contribution or 2% of pay each year	Employees under age 50: the lesser of $17,500 or earned income for the year Employees age 50 and over: the lesser of $23,000 or earned income for the year	Employees under age 50: the lesser of $17,500 or earned income for the year Employees age 50 and over: the lesser of $23,000 or earned income for the year	Employer contributions specified in plan documents Total contributions cannot exceed the lesser of $52,000 or 100% of pay
Withdrawals	Earnings and principal taxed as ordinary income Additional 10% tax on withdrawals made prior to age 59½* RMDs begin at age 70½ unless still working; for a 5%-or-more owner, RMDs must begin at 70½ even if still working	Earnings and principal taxed as ordinary income Additional 10% tax on withdrawals made prior to age 59½* RMDs begin at age 70½ unless still working; for a 5%-or-more owner, RMDs must begin at 70½ even if still working	Earnings taxed as ordinary income, if taken before age 59½; distributions of principal and earnings are tax-free if taken after age 59½* Additional 10% tax on withdrawals made prior to age 59½* RMDs begin at age 70½ unless still working; for a 5%-or-more owner, RMDs must begin at 70½ even if still working	Earnings and principal taxed as ordinary income Additional 10% tax on withdrawals made prior to age 59½* RMDs begin at age 70½ unless still working; for a 5%-or-more owner, RMDs must begin at 70½ even if still working

**Some exceptions apply.*

	Defined Contribution Plans			
	403(b)	457(b)	**Cash Balance Plans**	**Defined Benefit Plans**
Key Features	Earnings grow tax deferred Contributions can reduce employee's taxable income Employers can also permit contributions to designated "Roth 403(b)"	Earnings grow tax deferred Contributions can reduce employee's taxable income Contributions can be in addition to a 403(b) or 401(k)	Earnings grow tax deferred Higher contribution limits for older individuals	Earnings grow tax deferred Higher contribution limits for older individuals
Eligibility	Employees of religious, charitable, educational and other organizations described in IRC Sec. 501(c)(3), certain governmental organizations and public school systems	Employees of certain state and local governments and non-governmental entities tax exempt under IRC Sec. 501	Almost any employer, including corporations, self-employed individuals or partnerships Best for closely held firms with highly paid partners, owners or shareholders, such as law and accounting firms and medical practices	Almost any employer, including corporations, self-employed individuals or partnerships
Contributors	Employee and employer	Employee only	Employer only	Employer only
Maximum Contribution	Employees under age 50: the lesser of $17,500 or earned income for the year Employees age 50 and over: the lesser of $23,000 or earned income for the year Higher contribution limits may apply for some qualifying organizations and their employees	Employees under age 50: the lesser of $17,500 or earned income for the year Employees age 50 and over: the lesser of $23,000 or earned income for the year	Contributions are age-based and can be up to four or five times higher than for DC plans Maximum for employees age 55: $166,000 Maximum for employees age 62: $241,000	Annually determined contributions, based on plan terms and actuarial calculations
Withdrawals	Earnings and principal taxed as ordinary income; only earnings are taxed if a Roth 403(b) Additional 10% tax on withdrawals made prior to age 59½* RMDs begin at age 70½ unless still working	Earnings and principal taxed as ordinary income RMDs begin at 70½ unless still working	Generally rolled into an IRA upon retirement If not rolled over, earnings and principal taxed as ordinary income, and RMDs begin at 70½ unless still working	Distributions are taxed as ordinary income Can be rolled into an IRA upon retirement, if plan permits Benefits are paid after a specified event and based on plan terms

**Some exceptions apply.*

	Individual Retirement Account (IRA) Based Plans			
	Traditional IRA	Roth IRA	SEP IRA	SIMPLE IRA
Key Features	Earnings grow tax deferred Contributions can be deductible	Earnings grow tax deferred Contributions are *not* deductible and do *not* reduce employee's taxable income	Earnings grow tax deferred Contributions can be deductible for employer Simple to set up and maintain	Earnings grow tax deferred Contributions can be deductible for employer and reduce employee's taxable income
Eligibility	Any individual under age 70½ can contribute Contributions are deductible for individuals with earned income and/or spouse with modified AGI at or below phaseout range Married Filing Jointly, with employer plan: \$96,000–\$116,000 Married Filing Separately, with employer plan (spouse): \$181,000–\$191,000 Single or Head of Household, with employer plan: \$60,000–\$70,000	Any individual with earned income and/or spouse with modified AGI at or below phaseout range Married Filing Jointly: \$181,000–\$191,000 Married Filing Separately: \$0–\$10,000 Single or Head of Household: \$114,000–\$129,000	Self-employed individuals and small firms Employees must be at least 21 years old and have worked for the company for three of the last five years and earn at least \$550	Employers with 100 or fewer employees that do not maintain another retirement plan Employees must have earned \$5,000 or more in any of the prior two years and are expected to earn at least \$5,000 in the current year
Contributors	Employee only	Employee only	Employer only	Employee and employer
Maximum Contribution	Under age 50: the lesser of \$5,500 or earned income for the year Age 50 and over: the lesser of \$6,500 or earned income for the year	Under age 50: the lesser of \$5,500 or earned income for the year Age 50 and over: the lesser of \$6,500 or earned income for the year	Up to 25% of compensation, but no more than \$52,000 Lesser of 20% of net earnings from self-employment or \$52,000	Employees under age 50: the lesser of \$12,000 or 100% of pay Employees age 50 and over: the lesser of \$14,500 or 100% of pay Employer must match up to 3% of employee contributions or 2% of pay each year; can be 1% of employee contributions for two of five years For employees under age 50, total employer/employee contribution capped at \$24,000
Withdrawals	Earnings and pretax contributions taxed as ordinary income Additional 10% tax on withdrawals made prior to age 59½* RMDs begin at age 70½ unless still working	Distributions of earnings are tax-free if taken after age 59½ and if IRA is held for at least five years Earnings subject to ordinary income taxes, additional 10% tax on withdrawals prior to age 59½* No RMDs	Earnings and pretax contributions taxed as ordinary income Additional 10% tax on withdrawals made prior to age 59½* RMDs begin at age 70½ even if still working	Earnings and pretax contributions taxed as ordinary income Additional 25% tax on withdrawals made within the first two years of participation and 10% thereafter prior to age 59½* RMDs begin at age 70½ even if still working

**Some exceptions apply.*

Retirement Savings

DC Plans and IRAs

Best for: Anyone

Benefit: Tax deferral and avoidance

Tax Impact:

Limitations: Contribution limits

Complexity/Cost: Minimal for participant

Drawbacks: Penalties for accessing funds early

One of the easiest ways for taxpayers to defer income taxes and save for retirement is to contribute to a defined contribution (DC) salary deferral plan, such as a 401(k), or make tax-deductible contributions to an IRA. The tax benefit of these vehicles is powerful because investors garner investment growth on dollars that would have been paid in taxes if they had not invested in the plan.

How It Works

IRAs are set up by individuals; DC plans are employer sponsored, but the employee participant decides how much to contribute. DC plan participants under age 50 can defer up to $17,500 of salary into these plans; participants over 50 can make an additional $5,500 in contributions for a total of $23,000. Many employers also match employee contributions, typically up to a certain percentage of salary, in effect doubling the investment right off the bat. IRAs have much lower limits. (See tables on pages 16–18 for details.)

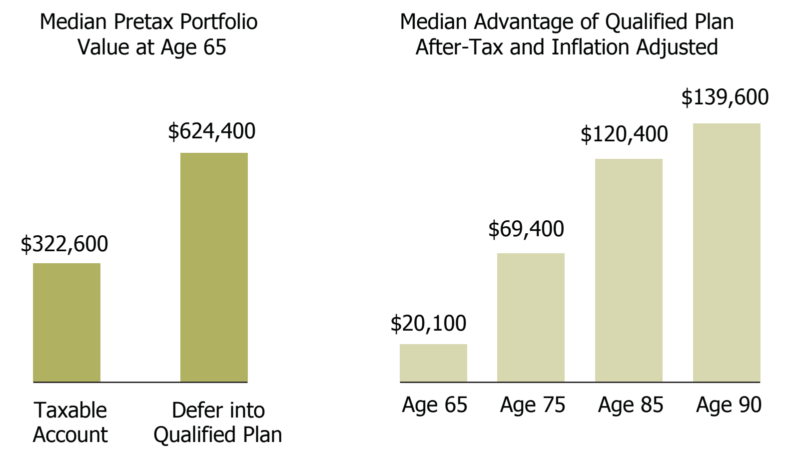
Quantifying the Benefit

The impact of investing pretax dollars versus saving in a taxable portfolio can be seen in the *display below*. At the top marginal tax rate, each $1,000 saved pretax to a retirement account would be worth only about $600 if saved after tax.

Let's consider the case of a 40-year-old employee in the top tax bracket who has the choice of saving $10,000 a year for 25 years: either $10,000

Tax-Deferred Growth in Qualified Plans Is a Big Benefit

Value of $10,000 Invested Annually for 25 Years, for a 40-Year-Old Employee



Both accounts are invested 60% in globally diversified equities and 40% in bonds. The tax-deferred account invests in taxable bonds; the taxable account, in municipal bonds.

Based on Bernstein's estimates of the range of returns for the applicable capital markets over the period analyzed. See Notes on Wealth Forecasting System for details. ***Data do not represent past performance and are not a promise of actual future results or a range of future results.***

To make a fair comparison, we assume that the tax-deferred portfolio is transferred to a taxable portfolio and that both taxable portfolios are liquidated and taxed at the age specified. All scenarios assume a top marginal federal tax rate and no state income taxes.

Source: AllianceBernstein

pretax through his employer's DC plan or about $6,000 after tax. In both cases, 60% of the portfolio is invested in globally diversified equities and 40% in fixed income. The tax-deferred portfolio invests in taxable bonds; the taxable portfolio invests in municipal bonds.

We project that by the time the employee retires at age 65, his 25 years of investments ($250,000 total saved) in the qualified plan would grow to $624,400, in the median case, while his 25 years of after-tax investments in the taxable account (about $150,000 total saved) would grow to $322,600. (If he was considering investments in an IRA, all these numbers would be about half as large, because the contribution limit is lower.)

The employee would owe more tax on withdrawals from the qualified plan than on withdrawals from the taxable account. Because he didn't pay tax on the salary deferred into the plan, he would owe taxes on every dollar withdrawn in retirement. In the taxable account, he would only owe tax on the interest, dividends or realized capital gains.

But even on an after-tax basis, the employee would be far better off investing in the qualified plan, as the right side of the *display on the prior page* shows. (To be fair, we compare the liquidation values of both portfolios at various ages and we adjust the values for inflation.)

We estimate that by the time the now-retired employee is 75, the qualified plan account would have a $69,400 (inflation-adjusted) edge over the taxable account. That advantage would grow over time, to $139,600 by age 90.

We calculate the benefit of tax deferral to be approximately 1.6% per year. This is a significant benefit. In general, employees should invest as much as possible through a qualified retirement plan, if available, before investing in a taxable portfolio. The earlier in life that employees begin making contributions, the greater the benefit they get from tax-deferred compound growth.

But investors should *not* put money in a plan if they think they may need the money before retirement. Withdrawals before age 59½ from a qualified DC plan or an IRA are subject to a 10% penalty tax, in addition to ordinary income tax, except under narrowly defined circumstances.

State Tax Considerations

Tax-deferred savings into a qualified plan or an IRA can help participants avoid (rather than defer) state taxes under certain circumstances. To the extent that a plan participant defers salary in a state with a high income tax rate and makes withdrawals during retirement in a state with a low income tax rate or no income tax at all, the plan participant should permanently avoid state income taxes on the salary deferred.

Retirement Savings

Cash Balance Plans

Best for:	Partners in professional practices and small business owners who seek greater tax-deferred savings
Benefit:	Tax deferral
Tax Impact:	
Limitations:	Contribution caps
Complexity/Cost:	Slightly higher cost to set up than other retirement plans; company must contribute on behalf of staff
Drawbacks:	Partners or owners must commit to at least three years of set contributions

For partners in professional practices and small business owners who are already contributing the maximum to their defined contribution plans, a cash balance plan can be a great opportunity for additional tax-deferred savings. Higher tax rates have increased the popularity of these plans—especially among older, high-earning doctors and lawyers saving for retirement.

How It Works

A cash balance plan is an employer-sponsored defined benefit (DB) plan with some features similar to a defined contribution (DC) plan. Contribution limits are based on age and, for older individuals, can be four or more times higher than for DC plans, as the *display at right* shows.

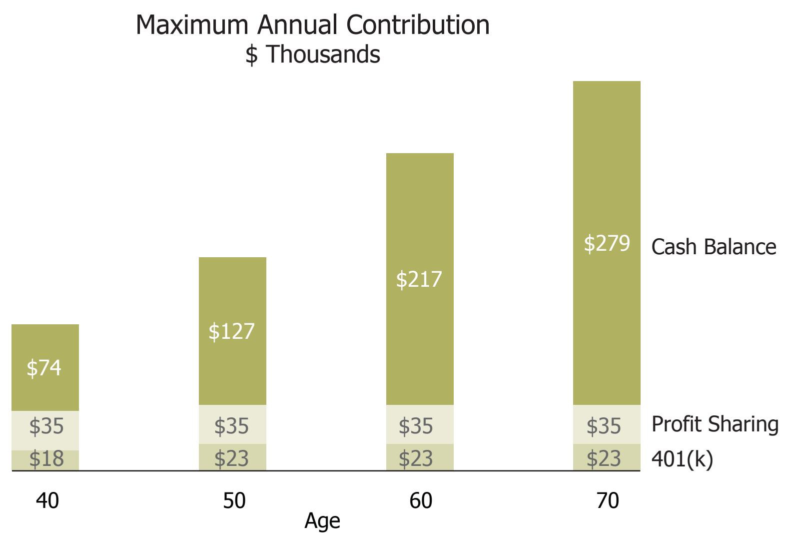
Each partner/participant can choose his or her own level of contribution but should commit to a contribution level for at least three years. Participants have a notional individual account balance that they can roll into an IRA when they leave the firm.

To establish the plan, the professional practice or small business engages an actuary to determine how much the partners/owners could defer for a given level of contributions to the staff. Typically, businesses that already have an existing 401(k) or profit-sharing plan and staff-to-owners ratio of less than 10 to one are good candidates for cash balance plans. The plan could significantly increase the deferral potential for principals while only modestly increasing firm contributions on behalf of the staff.

Quantifying the Benefit

As with a DB plan, assets in a cash balance plan are typically pooled and invested with the goal of matching a target rate of return. The target return can vary by plan design and demographics, but most cash balance

Cash Balance Plans Permit More Tax-Deferred Savings



Source: IRS and AllianceBernstein

plans have a return goal of 1% to 6%; many plans target a return of about 4%. Exceeding or falling short of the target return can cause over- or underfunding issues that plan sponsors would rather avoid.

But the chief benefit of these plans is not the modest return the partners earn while invested in them—it's the ability to defer substantially more income that can eventually be rolled into an IRA, or converted to a Roth IRA, for additional future tax-deferred or tax-free growth.

Additional Considerations

Historically, most cash balance plans have invested primarily in bonds, in order to reliably meet the target return and avoid the negative consequences of overfunding or underfunding in any one year. With interest rates near historic lows, this strategy has led to unsatisfactory results. But increasing the allocation to stocks and other return-seeking assets may increase the risk of overfunding or underfunding in a given year.

As a result, cash balance plans that add stocks or other return-seeking assets need to implement effective risk controls. Closely monitoring fund investments and de-risking the portfolio once it achieves the target return each year is advisable.

Retirement Savings

Roth Conversions

Best for:	Taxpayers who can pay up-front tax cost of conversion from taxable assets
Benefit:	Tax avoidance
Tax Impact:	
Limitations:	None
Complexity/Cost:	Minimal difficulty; high up-front tax
Drawbacks:	Legislative risk

Many taxpayers feel that they've missed their opportunity for a Roth conversion now that tax rates have risen and their assets have appreciated, both of which increase the up-front tax cost. But in our analysis, there is still a sizable benefit to the taxpayer and his or her heirs from paying taxes now to avoid taxes later.

The most common reason for converting traditional IRA or 401(k) assets to a Roth is to control future income by eliminating the need for required minimum distributions (RMDs) at retirement or age 70½. Avoiding RMDs may keep an investor's total taxable income in future years from being subject to a higher income tax rate or the 3.8% surtax on net investment income.

But the financial benefit comes mostly from using taxable assets to pay the conversion tax bill, which shifts more of the investor's overall portfolio to a tax-free environment. The investor can reduce the up-front tax by using cash, if available, to pay the tax due upon conversion, rather than selling assets and realizing capital gains.

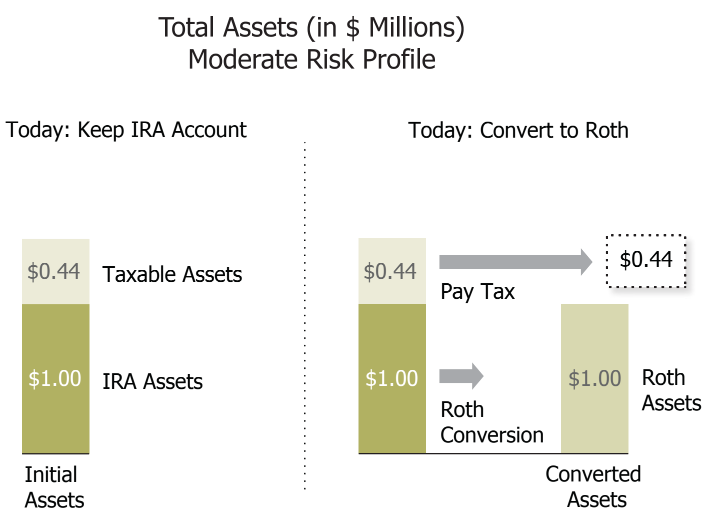
How It Works

Traditional IRA and 401(k) accounts are generally funded with *pretax* dollars and grow tax deferred. The income used to fund the account and the growth on that income are subject to income taxes only upon withdrawal.

Roth accounts, by contrast, are funded with *after-tax* dollars and grow tax free. They are not subject to income tax upon withdrawal, provided that the distributions are qualified. Unlike the participant in a traditional retirement account or IRA, a Roth account participant doesn't have to take RMDs.

The value of a traditional IRA, funded with pretax dollars, and the value of a Roth IRA, funded with after-tax

Roth Conversion: Paying Tax Now to Avoid More Later



Tax on converting a $1 million traditional IRA to a Roth IRA would total $435,200.
Source: AllianceBernstein

dollars, would be identical upon liquidation if the investment returns were the same and the investor's tax bracket didn't change.

The financial benefit comes from using the conversion to a Roth IRA to get more assets into an environment where they can grow tax free, without requiring a distribution during the participant's life.

Investors who convert a traditional IRA or 401(k) to a Roth must pay the taxes that were deferred. Paying the tax with funds outside the IRA or retirement plan allows the investor to preserve the full value of the assets inside the plan.

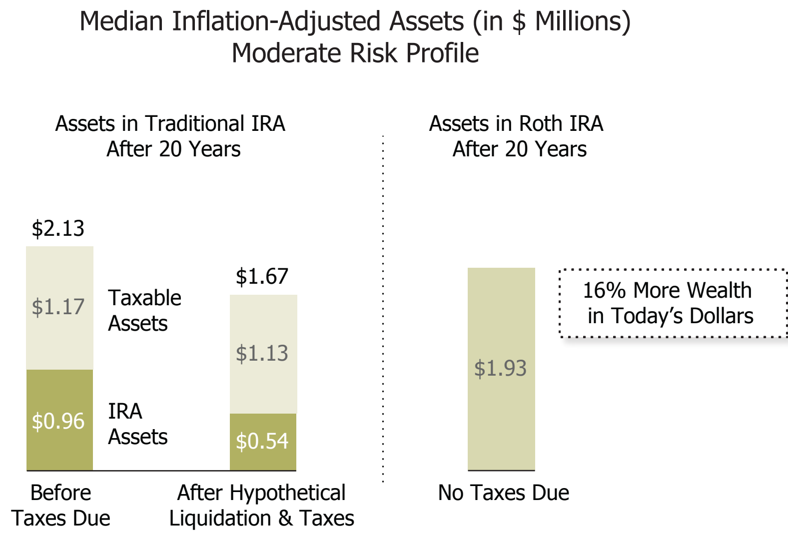
Employers may also set up Roth versions of their defined contribution plans. Employees can contribute after-tax dollars to a Roth retirement plan directly, or convert their existing plan to one. Conversion can make financial sense at any age, as long as you have the money available outside the account to pay the tax due.

Quantifying the Benefit for the Owner

Let's say a 65-year-old investor in the top tax bracket has a $1 million IRA account and $435,200 in cash that he doesn't need to fund retirement spending. As the *display on the prior page* shows, he can either:

- Keep the IRA and invest the cash in a balanced portfolio; or
- Convert the IRA to a Roth and use all the cash to pay the taxes.

Roth IRA Creates Greater After-Tax Wealth for Owner



The account values for an investor age 65 taking required minimum distributions at 70½; tax on converting a $1 million traditional IRA to a Roth IRA would total $435,200.

Assumes any traditional IRA assets remaining after 20 years are liquidated, resulting in a tax liability of 39.6% federal and 6.5% state on ordinary income, and 23.8% federal and 6.5% state on long-term capital gains (includes Medicare surtax on net investment income). All assets are assumed to be invested in 60% globally diversified equities and 40% intermediate-term fixed income. Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years. See Notes on Wealth Forecasting System for details. ***Data do not represent past performance and are not a promise of actual future results or a range of future results.***

Source: AllianceBernstein

In both cases, we assume the assets remain invested in a portfolio with a moderate risk allocation.

We project that after 20 years, the investor's inflation-adjusted total assets in the traditional IRA and taxable account will grow to $2.13 million, in the median case, as shown in the *display above*. The IRA will almost keep pace with inflation after RMDs and will be worth $0.96 million in today's dollars, while the taxable account will grow to $1.17 million, including reinvestment of RMDs after tax from the IRA. If the investor liquidated the account at this point, taxes due would reduce its value to $1.67 million.

We project that the Roth account will only grow from $1 million to $1.93 million after inflation in the same time span, but no taxes are due. On an after-tax basis, the investor would be much better off with the Roth account than with the traditional IRA.

Quantifying the Wealth Transfer Benefit

Now, let's turn to the wealth transfer benefits. Let's say that the same investor dies at age 85.

If a beneficiary inherits a traditional IRA and a taxable account, the cost basis of the taxable account steps up, eliminating tax due on embedded gains. Thereafter, the beneficiary owes tax only on interest, dividends or future capital gains from the taxable account, as well as ordinary income tax on distributions from the IRA.

If the beneficiary inherits a Roth account, however, there is no income tax due initially or on the distributions.

Traditional IRAs, traditional DC plans and their Roth equivalents all require minimum distributions to non-spouse beneficiaries over the expected life of the beneficiary. For example, if the heir is age 55, the RMDs are calculated assuming that he lives another 30 years.

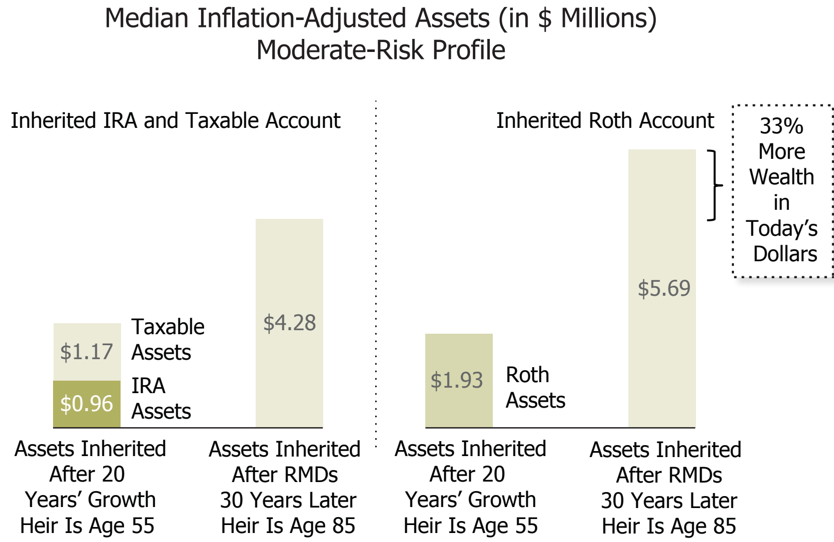
So, let's look at the liquidation value of both accounts after 30 years, assuming that they are invested in moderate-risk portfolios. To make a fair comparison, we assume that the RMDs from both portfolios are reinvested.

We project that the total liquidation value of the taxable account and traditional IRA will be $4.28 million after taxes, in the median case, and the value of the Roth IRA will be $5.69 million, 33% more as the *display at right* shows. The greater value of the Roth reflects the tax savings on the RMDs. The only tax that the beneficiary of the Roth pays is on investment earnings from reinvesting the distributions.

A Roth may also provide an estate-tax benefit. Any taxable assets used to pay taxes on a Roth conversion are left out of calculations of the estate's value, reducing the amount by which the estate value could exceed the federal estate tax exclusion, which is now $5.34 million per decedent.

The rules governing Roth conversions are intricate. Consulting a tax advisor is critical.

Roth IRA Creates Greater Wealth for Heirs



Assumes assets inherited by a 55-year-old non-spouse beneficiary who will take RMDs on beneficiary IRA or beneficiary Roth, using IRS-determined life expectancy of 29.6 years. Beneficiary assumed to be in the top tax bracket, resulting in a tax liability of 39.6% federal and 6.5% state on ordinary income, and 23.8% federal and 6.5% state on long-term capital gains (includes Medicare surtax on net investment income). All assets are assumed to be invested in 60% globally diversified equities and 40% intermediate-term fixed income. Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 50 years. See Notes on Wealth Forecasting System for details.

Data do not represent past performance and are not a promise of actual future results or a range of future results.

Source: AllianceBernstein

Risks

Investors considering a Roth conversion must be confident that they won't need the money for five years, because Roth account earnings may become taxable to the extent the investor withdraws money from any Roth account within five years of establishing the first one. Earnings on a Roth are subject to a 10% penalty tax on withdrawals before age 59½, unless the investor becomes disabled, dies or needs the money to buy a first home.

There is also legislative risk. Tax laws can be changed, and some people have suggested that allowing Roth accounts to grow tax-free forever is unfair. One proposal that has made its way into the presidential budget, but not into legislation, calls for allowing only five years of tax-free growth for inherited beneficiaries.

Some investors also fear that they will pay the up-front tax for a Roth conversion, only to see the investments immediately fall in value. This risk, however, isn't real, as explained on the next page.

The Roth Do-Over

Taxpayers typically cite two fears that prevent them from converting their IRAs to Roths. The first is the fear of a tax law change, discussed on the prior page. The second is the fear that the market could drop right after a conversion.

While we can't predict short-term swings in the stock market, there is no reason for investors to fear paying tax up front on a conversion that quickly declines in value. Why? The tax code offers a rare "do-over" on Roth conversions, formally called a recharacterization.

To recharacterize a recently converted Roth, the taxpayer simply rolls all or part of the funds converted from a traditional IRA to a Roth back into a traditional IRA. A recharacterization is like taking a mulligan shot in golf: The conversion never happened, as far as the IRS is concerned. If the taxpayer later wants to convert the assets back to a Roth, he just needs to wait 30 days or for a tax year after the initial conversion, whichever is later.

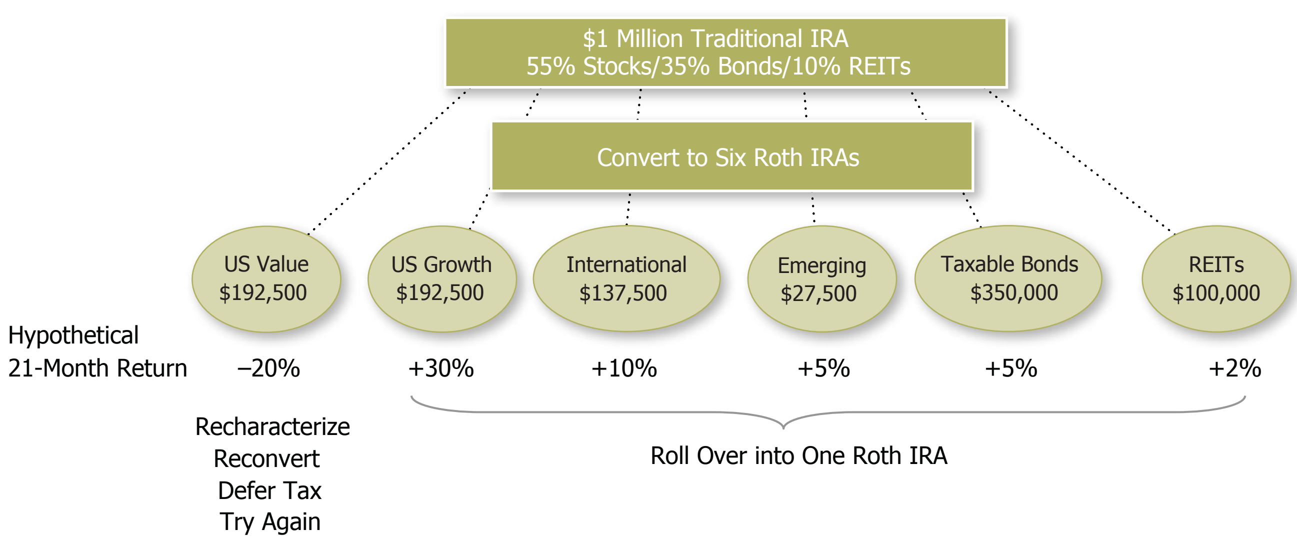
A taxpayer can recharacterize a Roth conversion at any time up until the last filing deadline of the tax year: October 15 of the year after making the conversion. However, any tax that the taxpayer owes on the conversion must be paid by April 15 to avoid penalties.

Savvy taxpayers can use the recharacterization rules to their advantage. One strategy is to split IRA investments into separate Roth accounts upon conversion, which allows the taxpayer to segregate the assets that generate strong returns from weaker performers (see *display below*). Before the tax is due or before the last tax return is filed, the taxpayer recharacterizes the poor performers to avoid paying the up-front tax due on them. If he chooses to convert those assets back to a Roth later, he would incur less tax on the conversion, assuming that the poor performers remain at lower prices.

Even if a taxpayer is considering conversion of only some of his IRA assets, this strategy could make sense. The taxpayer would convert the entire IRA to several Roth IRA accounts, keep the best performers, and recharacterize the rest.

After converting a portion of the IRA, the investor may want to further diversify the remaining IRA assets, since the accounts will be subject to RMDs. It's generally wise to put growth-oriented investments into the Roth account, since their growth won't be taxed.

Splitting Assets in a Roth Conversion Enables a Do-Over for Lagging Portfolios



Returns are for illustrative purposes only. They do not represent past results and are not a promise of future results.
Source: AllianceBernstein

Retirement Savings

Variable Annuities

Best for:	High-income investors with long time horizons
Benefit:	Tax deferral
Tax Impact:	Varies widely
Limitations:	See below
Complexity/Cost:	Cost can be high
Drawbacks:	Less attractive tax treatment than other tax-deferred vehicles

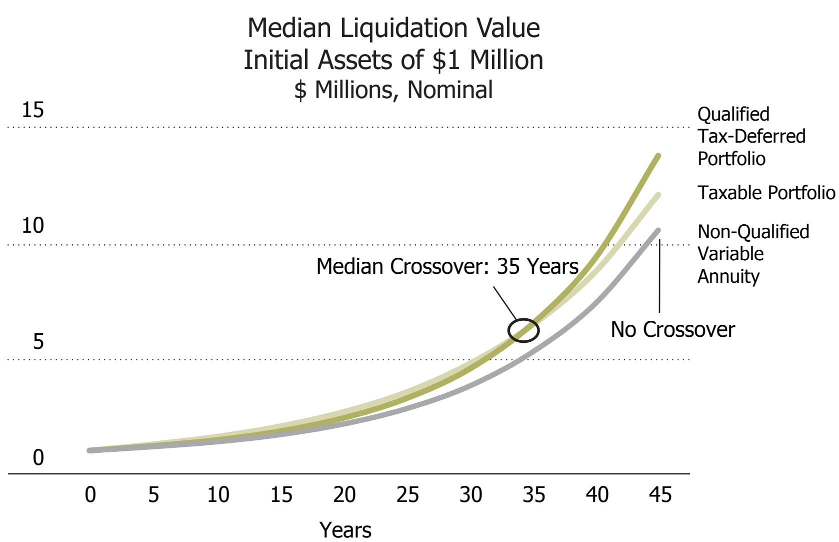
Non-qualified annuities are often proposed as substitutes for a taxable investment portfolio on the grounds that they offer greater security and tax deferral. In particular, variable annuities (VAs) are often championed as a way for investors to participate in the upside potential of the capital markets while deferring current income taxes and potentially limiting their downside risk through guarantees. Our analysis indicates that the benefits are often less impressive than they appear.

How Variable Annuities Work

VAs are contracts between the annuity owner and an insurance company. The annuity owner makes contributions, called premiums, to the variable annuity and invests them in investment portfolios within the annuity. The returns from these investments are tax deferred until they are withdrawn.

Many VAs offer features or optional riders that may limit the investor's downside risk by providing a guaranteed minimum investment return or guaranteed annual withdrawal right if market returns are poor. In recent years, fees for these guarantees have increased to reflect insurance companies' high costs for honoring guarantees in force during the 2008–2009 market drop.

Years for Tax Deferral to Offset Higher Taxes and Fees



Asset values represent estimated liquidation value after taxes, assuming top federal and 5.0% state tax rates, and 3.8% tax on net investment income. "Median" means 50th percentile outcome of Bernstein's Wealth Forecasting System. The "Qualified Tax-Deferred Portfolio" is not subject to the 3.8% net investment tax. Assumes all three portfolios are invested 60% global stocks and 40% bonds. Global stocks means 21% US diversified stocks, 21% US value stocks, 21% US growth stocks, 7% US small- and mid-cap stocks, 22.5% developed international stocks and 7.5% emerging markets stocks. Bonds mean intermediate-term municipal bonds in the "Taxable Portfolio" and intermediate-term taxable bonds in the "Qualified Tax-Deferred Portfolio" and "Non-Qualified Variable Annuity." Assumes that a total annual mortality and expense charge of 0.50% applies to the "Non-Qualified Variable Annuity" and that investment management fees are equivalent between all three portfolios.

Based on Bernstein's estimates of the range of returns for the applicable capital markets over the applicable period. See Notes on Wealth Forecasting System for details. ***Data do not represent past performance and are not a promise of actual future results or a range of future results.***

Source: AllianceBernstein

Investors whose primary interest in VAs is tax deferral and not downside protection can significantly lower their costs by opting for contracts without guarantees. For these annuities, the fees typically include a mortality and expense charge, investment management fees on the underlying portfolios, and surrender charges if the investor exits the annuity within a certain period of time after signing the contract.

VAs allow investors to significantly increase their tax-deferred holdings. There are no statutory limits on contributions to VAs, whereas traditional IRAs have an annual contribution limit of $5,500 in 2014 ($6,500 with catch-up for participants age 50 or older).

The question facing investors is whether the tax deferral from investing through a VA is sufficiently attractive to offset their unfavorable tax treatment and fees.

As with an IRA in which an investor makes nondeductible (or after-tax) contributions, the premiums on a VA grow on a tax-deferred basis, and distributions or withdrawals of gains are subject to ordinary income tax rates, rather than the lower rates on long-term capital gains and qualified dividends that apply to assets held in a taxable portfolio.

In contrast with IRAs, the earnings withdrawn from a VA are considered net investment income and thus potentially subject to the 3.8% surtax. Thus, earnings withdrawn from a VA could be taxed at a rate as high as 43.4% at the federal level, while earnings withdrawn from an after-tax IRA could be taxed only at a maximum federal rate of 39.6%.

Also like a traditional IRA funded with after-tax contributions, VAs generally do not receive a step-up in cost basis upon the owner's death, as a taxable portfolio does. The gain within the VA or traditional IRA is treated as income in respect of a decedent and is passed on to the beneficiary.

Quantifying the Benefit

To determine whether the tax-deferral benefit of a VA without guarantees justifies the extra layer of fees and relatively unattractive tax treatment upon withdrawal, we compared how much after-tax wealth would be created over time in a VA, a traditional IRA funded with after-tax contributions and a taxable portfolio.

In all three cases, we assumed that 60% of the portfolios is invested in globally diversified stocks that generate qualified dividends and long-term capital gains over time. The other 40% of each portfolio is invested in bonds. In the taxable portfolio, the bonds are federally tax-exempt municipal bonds. In the after-tax IRA and VA portfolios, the bonds are a diversified mix of corporate and government bonds that create taxable ordinary income. We assume equivalent investment management fees.

As the *display on the prior page* shows, the liquidation value of both the after-tax IRA and the VA initially lags the taxable portfolio because distributions on the IRA and VA are taxed as ordinary income, while distributions from the taxable portfolio are taxed as capital gains and qualified dividends.

In the median case, it will take 35 years for the after-tax IRA investment to catch up to the taxable portfolio, which we refer to as the "crossover point." In the case of the VA, the crossover does not occur within the 45 years studied because the annuitant has to pay the additional 3.8% tax on net investment income on withdrawals and an annual contract fee of 0.50%.

The display suggests that the taxable portfolio is generally the most effective way to invest after-tax dollars, and an after-tax IRA is more effective than a VA. Investors seeking to make larger annual contributions than are possible with an after-tax IRA would generally do better contributing taxable assets to a Roth account, which would provide a significant benefit over a much shorter horizon.

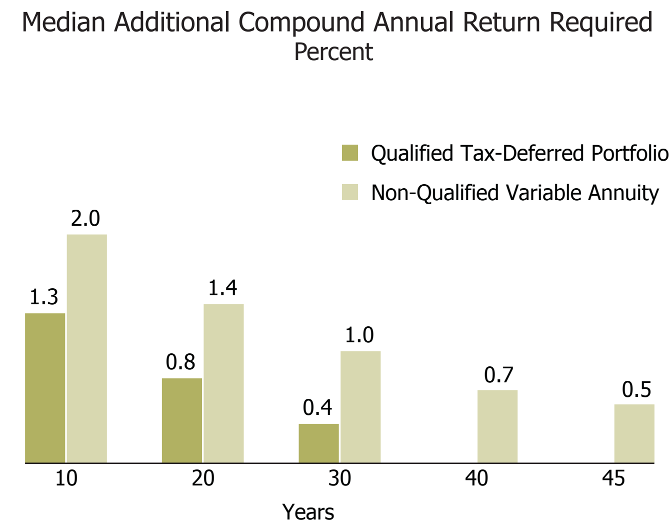
VAs and Tax-Inefficient Assets

But after-tax IRAs and VAs may be more attractive than taxable portfolios as a vehicle for some investments that are subject to high taxation—particularly, high-turnover portfolios, such as hedge funds, that generate significant short-term capital gains, and global bond portfolios that are taxed as ordinary income at both the federal and state levels.

To determine which investments should make the cut, we calculated the return required for the investments to outperform within a VA versus another investment with similar risk held in a taxable portfolio managed on a tax-aware basis. As the *display at right* shows, the higher the expected-return premium versus a tax-aware investment, the sooner the portfolio would reach the crossover point.

The terms of VAs vary widely. No one example can highlight all the potential issues that may arise in connection with a particular VA proposal. Each such proposal must be evaluated on its own merits, taking into consideration the particular investor's goals and circumstances.

Return Needed to Offset Higher Taxes and Fees



Additional compound annual return required for the "Qualified Tax-Deferred Portfolio" or "Non-Qualified Variable Annuity" to have the same after-tax wealth as the taxable portfolio at the given year. Calculation is based on the estimated median liquidation value, after taxes, assuming top federal and 5.0% state tax rates, and a 3.8% tax on net investment income. "Qualified Tax-Deferred Portfolio" is not subject to the 3.8% net investment tax. "Median" means 50th percentile outcome of Bernstein's Wealth Forecasting System. Assumes portfolios are invested 60% global stocks and 40% bonds. Global stocks means 21% US diversified stocks, 21% US value stocks, 21% US growth stocks, 7% US small- and mid-cap stocks, 22.5% developed international stocks, and 7.5% emerging markets stocks. Bonds mean intermediate-term taxable bonds. Assumes a total annual mortality and expense charge of 0.50% applies to the "Non-Qualified Variable Annuity" and that investment management fees are equivalent between both portfolios.

Based on Bernstein's estimates of the range of returns for the applicable capital markets over the applicable period. See Notes on Wealth Forecasting System for details. ***Data do not represent past performance and are not a promise of actual future results or a range of future results.***

Source: AllianceBernstein

Taxes and Planning

Taxes are only *one* critical component of financial planning; our work with investors on tax-related strategies is performed within the context of their overall financial plan.

For many clients, the first step in building a plan is determining the amount of money needed to sustain lifetime spending—what we call "core capital." We calculate core capital so that the investor has a high degree of confidence in achieving his goals even if markets are choppy, inflation is high or he lives an exceptionally long life.

Any money the investor has above core capital is "surplus capital" that can go to fund additional spending, a vacation home, a legacy for the kids, philanthropy or other goals.

Our core/surplus framework is central to how we analyze a wide range of investor questions, such as:

- How long must a professional keep working before he can prudently retire?
- How could a retiree adjust her asset allocation and spending to maximize the odds that she won't outlive her savings?
- What's the most tax-efficient vehicle to provide a legacy?
- How can business owners decide whether to sell, and on what terms?

Each of these questions requires rigorous analysis, and the more complex the question the more detailed the model. Bernstein can prepare a customized Wealth Forecasting Analysis to evaluate all of the above questions and the strategies discussed in this book.

We can conduct these analyses at a high level, or with as much detail as an investor is willing to provide.

Sometimes, providing information regarding one request may lead to discussions of other possibilities—and the need for additional data. That's what we think it takes for investors to make informed choices.

Contact us to learn more.

Charitable Donations

Outright Gifts

Best for:	All taxpayers
Benefit:	Tax avoidance
Tax Impact:	
Limitations:	Subject to AGI limits on charitable contributions; Pease limitations not likely to be a problem
Complexity/Cost:	Minimal
Drawbacks:	None

Few strategies for avoiding tax are as widely available, highly valuable and easy to use as charitable donations. Anyone who gives to a qualified charity or an educational institution can deduct the value of the contribution from his or her taxable income, and thus reduce his or her bill.

The higher the taxpayer's marginal tax rates, the greater the tax savings from a charitable donation. Thus, the recent increase in marginal tax rates has significantly increased the tax incentives for charitable donations.

The Urban-Brookings Tax Policy Center estimated that the new tax law is likely to increase charitable giving by the wealthiest 1% of the population by 6.2%, or $3.4 billion.

But the rules around charitable giving are complex. The limitations on the income tax deduction vary with the donor's income level, type of property being contributed, and the nature of the recipient charity (for example, public charity vs. private foundation). Documentation requirements for charitable donations include appraisals in some cases. Consultation with your tax advisor is critical.

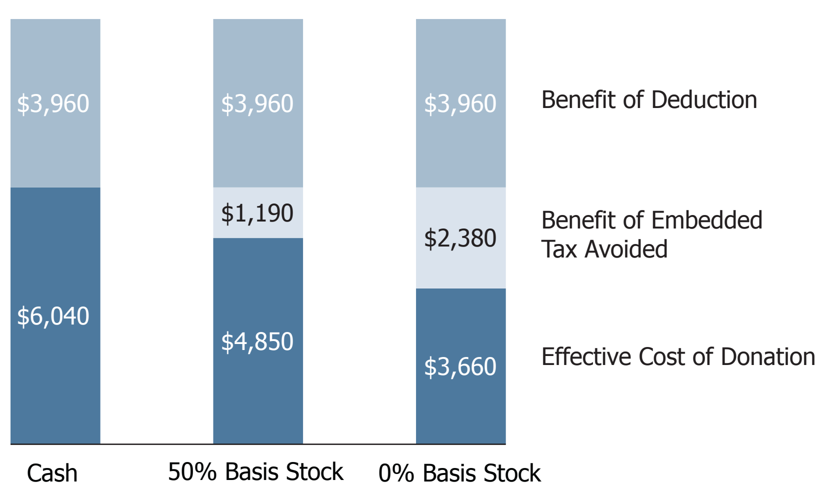
Quantifying the Benefits

For someone in the top (39.6%) tax bracket, deducting the value of a $10,000 cash gift to a public charity reduces federal income tax owed by $3,960. That reduces the effective cost of the gift to $6,040. In states with income tax, the effective cost may be lower.

Gifts of appreciated stock or other assets not only reduce tax on ordinary income but can also reduce or eliminate tax on capital gains. The additional tax savings can be enormous, as the *display below* shows.

Not All Charitable Gifts Offer the Same Tax Savings

$10,000 Gift (Donor in Top Income Tax Bracket)



Deduction limited to 50% of AGI in year of cash gift or 30% of AGI in year of gift of appreciated public stock. Benefit of deduction assumes full use of deduction against income otherwise taxed at 39.6% tax rate. For simplicity, we have ignored the Pease limitation of itemized deductions for donors with high AGIs, although this limitation is very unlikely to affect the charitable deduction in states with an income tax. Gift is to a public charity.

Source: IRS Publication 526 and AllianceBernstein

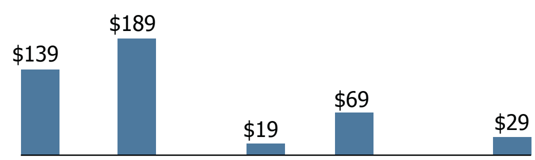
Charity Still Reduces Tax for Most Filers, Despite Pease

Married Couple with AGI of $1 Million
Would Like to Make a $50,000 Gift to Charity

$ Thousands

	Homeowner High-Income-Tax State		Homeowner No-Income-Tax State		Renter No-Income-Tax State
	No Gift	Gift	No Gift	Gift	Gift
State and Local Taxes	$90	$90	—	—	—
Property Taxes	40	40	$40	$40	—
Mortgage Interest	30	30	—	—	—
Charitable Contribution	—	50	—	50	$50
Pease Limitation	(21)	(21)	(21)	(21)	(21)

Total Deduction



Itemized deductions are reduced by the lesser of: 1) 3% of AGI in excess of $300,000 for joint filers; or 2) 80% of total deductions. In this example, 3% of AGI in excess of $300,000 is $21,000.

Source: AllianceBernstein

Someone in the top bracket who gives $10,000 in stock that he got for nothing—perhaps when founding the firm—can avoid paying the 23.8% tax on the stock's $10,000 gain. The extra tax savings would cut the effective cost of the donation to $3,660.

Limitations

To receive a deduction for the fair market value of a capital asset, it must be held for more than one year.

The tax code permits charitable deductions of up to 50% of adjusted gross income (AGI) in the year of the cash gift, and up to 30% in the year of a gift of appreciated stock. However, the deduction can be carried forward for five years. Deferring a deduction is valuable if a taxpayer wants to give more than he can deduct in one year, perhaps to help a charity get a matching grant.

There has been much talk in tax circles about the so-called Pease limitation. While this provision does raise taxes for the well-off, it does not reduce tax savings from making a charitable donation.

For taxpayers with AGIs above certain thresholds ($300,000 for married couples; $275,000 for heads of households; $250,000 for a single person), Pease limits the itemized deductions that they can take by 3% of AGI above the threshold, or 80% of total deductions—whichever is less. But in practice, the Pease limitation is relevant for a very few high-income taxpayers who have very limited deductions, because they rent their home and live in a location with no city or state income tax.

Consider the case of a married couple with $1 million of AGI who would like to make a $50,000 gift to the school where they met. The *left column of the display above* shows that if the couple lives in a state with high taxes and owns their home, they might have $160,000 in itemized deductions for state and local taxes and mortgage interest. The Pease limitation would cut those deductions by $21,000: 3% of their $700,000 income above $300,000. If the same couple makes a $50,000 gift, their total itemized deductions would rise to $210,000—before the same $21,000 reduction.

That is, the Pease limitation would reduce the couple's deductions by $21,000, whether or not they make the gift. It thus raises their tax bill by the top federal income tax rate, 39.6%, times $21,000, or $8,316. But if they make the gift, they can still deduct $50,000 more.

The same principle applies if the couple lives in a state and city without local income taxes, owns their home and has paid off their mortgage. If they don't make a charitable gift, they could deduct $40,000 for property taxes minus the $21,000 Pease limitation, or $19,000. If they make the gift, they could deduct $50,000 more.

Charitable Donations

Donor-Advised Funds and Private Foundations

Best for:	People who want to make a commitment greater than annual charitable gifts
Benefit:	Tax avoidance; immediate and perpetual philanthropy
Tax Impact:	
Limitations:	Subject to AGI limits on charitable contributions
Complexity/Cost:	Greater for private foundations
Drawbacks:	Irrevocable gift; legislative risk

Individuals who now have more money or time to devote to philanthropy may feel that writing checks to their favorite charities is no longer enough. They may want to set longer-term priorities for giving, involve other members of the family in decisions or establish a philanthropic program that outlives them. If so, it makes sense to consider channeling donations through a vehicle such as a donor-advised fund or a private foundation.

Donors focused on reducing costs and administrative tasks and retaining the option to make anonymous gifts will probably be more comfortable with a donor-advised fund. Donors most concerned with control and perpetuity may well favor a private foundation. Some donors may choose to establish both and use each for specific purposes.

Similarities

With both a donor-advised fund and a private foundation, the donor irrevocably commits assets to charity and receives a charitable income tax deduction in the year he makes the commitment. Both provide tax-advantaged growth for the assets. They are regulated under Section 501(c)(3) of the tax code. The IRS may require appraisals for gifts of assets other than cash and marketable securities.

A powerful advantage of both vehicles is that they enable donors to decouple decisions about asset donation and grantmaking. For example, donors can give highly appreciated assets that the private foundation or donor-advised fund can sell to reinvest, without incurring capital gains taxes, although the foundation will incur excise taxes. In subsequent months or years, the donor can use these funds and their investment earnings to make grants to charity.

Differences

A donor-advised fund is an account or a fund that the donor creates at a sponsoring organization that is itself a public charity. The donor funds the account by donating cash or assets,

Donor-Advised Funds and Private Foundations: Summary

	Donor-Advised Fund	Private Foundation
Operating costs	Low, but sponsor may charge investment and administrative fees ranging from 0.6% to 3%	High, but declines as assets rise
Tax deductions for contributions Cash Marketable securities Private securities	Deductions limited to: 50% of AGI 30% of AGI Fair market value, at 30% of AGI	Deductions limited to: 30% of AGI 20% of AGI Cost basis, at 20% of AGI
Excise tax	None	1% or 2% of income
Control	Contingent on sponsor	Absolute
Funding	Excess business holdings can be a challenge	Excess business holdings can be a challenge
Annual grants	No minimum or maximum	Required 5% distribution
Anonymity	Achievable if desired	No
Perpetuity	Contingent on sponsor	Yes
Compensation of board members	No Yes	Yes
Legislative risk		Yes

Source: IRS and AllianceBernstein

and provides advice about investments and grants. The sponsoring entity handles check writing, record keeping and other administrative tasks.

A private foundation is a freestanding corporation or trust that the donor establishes and controls. (We discuss here private nonoperating foundations, not operating foundations and supporting organizations.) The donor or his employees are responsible for writing checks, corresponding with grantees, keeping records and performing all administrative duties.

Tax Issues

Rules regarding the tax deductibility of donations are typically more generous for donor-advised funds than for private foundations, as detailed in the *display on the prior page*. With both vehicles, charitable income tax deductions above the stated limits can be carried forward for as many as five more tax years.

Earnings and income on a donor-advised fund are generally not subject to taxation. Donor-advised funds can give away all or none of their assets in any year. Private foundations, by contrast, are subject to an excise tax of 1% or 2% on the income and realized capital gains they generate each year. A private foundation is required to spend at least 5% of its asset value each year.

Both vehicles can become subject to taxation at the corporate rate (35%) for any unrelated business taxable income (UBTI) that they receive. This kind of income can arise from investments in private equity funds, REITs, and other partnerships or LLCs that use debt to acquire property.

Operating Costs

Private foundations are generally more expensive to establish and run than donor-advised funds. Applying for 501(c)(3) status is likely to entail legal fees, and the donor is likely to need accounting and bookkeeping help to prepare the foundation's tax returns. Typically, a private foundation is most cost-effective for charitable programs of $5 million or more.

Donors face none of these costs if they set up an account with an existing donor-advised fund program, but the administrative and investment fees may run from less than 1% to nearly 3%. The minimum starting balance is typically $10,000–$25,000.

Control

Donating assets to a donor-advised fund means relinquishing legal control, although in recent years, many administrators have provided donors with the look and feel of greater control to attract new donors and expand their programs.

At a private foundation, directors or trustees control investment practices, grantee selection, grant amounts, grant timing, and decisions regarding single- or multiyear commitments.

Anonymity vs. Bully Pulpit

If the donor to a donor-advised fund prefers to give anonymously, most donor-advised programs will draw checks in a way that does not disclose the donor's identity. Donor-advised funds can also meet the needs of donors who want recognition for gifts.

A private foundation cannot withhold its identity when making a grant. Indeed, it often provides opportunities for publicity. Many donors use their foundations as a bully pulpit to attract attention to the causes they favor.

Perpetuity

A private foundation is often described as a perpetual philanthropic vehicle—one that will last forever. A foundation could go on for hundreds of years, affording the family ongoing control over the assets in its portfolio.

Whether succeeding generations can participate in a donor-advised fund program depends on the sponsoring organization's rules.

Legislative Risk

Both vehicles could be vulnerable to changes in the legal code. Some lawmakers have attempted to reduce the value of the charitable income tax deduction to private foundations, reduce the tax-advantaged growth in their portfolios and increase the required minimum spending rate.

There have been parallel efforts to regulate donor-advised funds and add to their immediate charitable impact.

In both cases, these efforts have been unsuccessful, but legislative risk remains.

Charitable Donations

Charitable Gift Annuities

Best for:	Typically donors over age 60 worried about outliving their assets
Benefit:	Tax avoidance and deferral
Tax Impact:	
Limitations:	Only some charities offer them; deduction subject to AGI limits on charitable contributions (see p. 31)
Complexity/Cost:	Minimal, but ongoing
Drawbacks:	Irrevocable gift; credit risk

Today, many charitable individuals feel forced to reassess their philanthropic plans. Shaken by stock market gyrations, economic uncertainty and the possibility that they may live well into their 90s, even people of substantial means are deferring gifts out of fear that they could someday run out of money. Many assume that retirement funding and charitable giving are competing goals—that any dollar given to charity means a dollar less in their retirement account.

But a charitable gift annuity (CGA) allows donors to make charitable gifts while also providing them with a stream of cash for retirement expenses. Like the commercial annuities sold by insurance companies, charitable gift annuities can be seen as longevity insurance: They protect donors against the risk of outliving their assets.

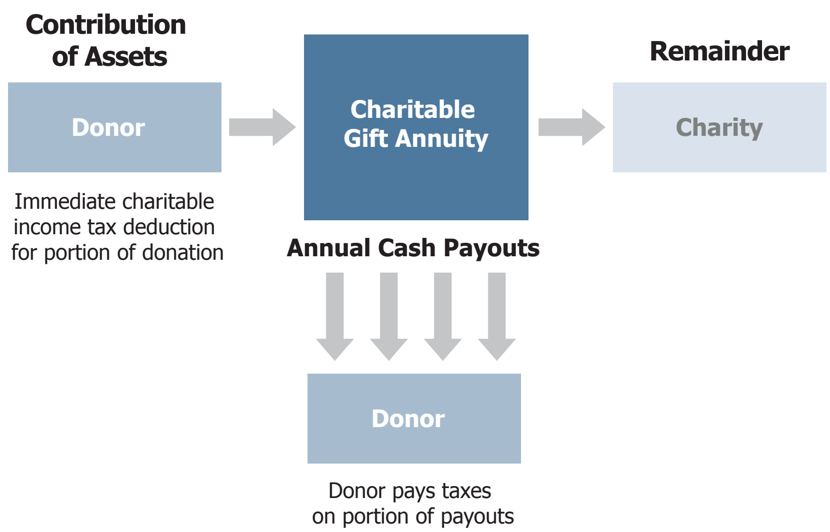
How CGAs Work

Nonprofit organizations establish CGAs, which allow donors to make a charitable contribution, get a tax deduction for a portion of the contribution now and receive fixed payments for life (as the *display below* shows). After the donor's death, any remaining assets pass to the charity.

CGAs distribute less income than commercial annuities do; this sacrifice in yield creates the charitable contribution. The American Council on Gift Annuities' suggested rate for a single life annuitant age 69 to 76 is between 5% and 6%. That may be attractive to donors in a period when bonds yield 2%–3%.

In the year the annuity is purchased, the donor is entitled to a charitable income tax deduction for the amount contributed minus the present value of the future annuity payments, based on the donor's life expectancy. If the donor contributes cash, a portion of

Give and Hedge Longevity Risk: Charitable Gift Annuities



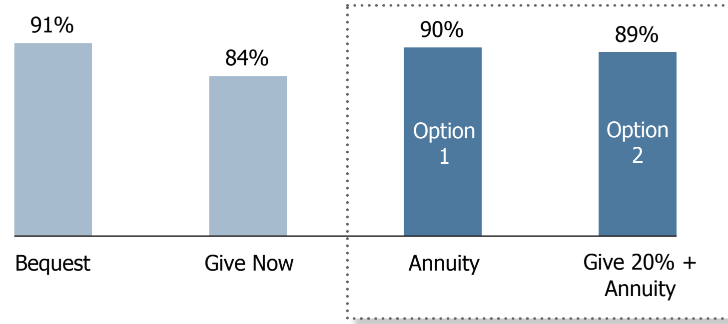
Immediate deduction calculated pursuant to Sections 7520 and 664 of the Internal Revenue Code of 1986, as amended, and the Treasury regulations thereunder

Source: IRS and AllianceBernstein

the annuity payments will be treated as a tax-free return of principal and a portion as ordinary income. If a donor gives low-cost-basis assets, generally no capital gains tax will be due immediately, although a portion of the annual payments will be subject to capital gains tax and a portion will be taxed as ordinary income.

A CGA Reduces Risk of Running Out of Money

Financial Security:
Odds of Meeting Spending Plan*



Odds of meeting spending plan defined as having assets greater than $0 in year 30. The income tax deduction for the gift annuity is calculated to be 31% of the amount contributed, assuming two 70-year-old current beneficiaries, an annuity equal to 4.6% of the contribution amount and a Section 7520 rate of 2.2%. For the first 20½ payments, the annuity is assumed to be 73% return of principal (50% taxed as a capital gain) and 27% income (taxed as ordinary income). Beginning in year 21, the entire amount is assumed to be taxed as ordinary income. Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 30 years. See Notes on Wealth Forecasting System for details.* ***Data do not represent past performance and are not a promise of actual future results or a range of future results.*

Source: AllianceBernstein

Quantifying the Benefit

Let's consider the case of a hypothetical retired couple in their early 70s who would like to donate to charity $100,000 of stock in a former employer, with a cost basis of $50,000. The couple has $1 million in other investments, including $650,000 in personal savings and $350,000 in retirement accounts. They receive Social Security but need to spend from their portfolio to meet their $70,000 in annual expenses.

The couple understands the tax benefits of giving their low-basis stock to charity during their lives but fear that if they do, they might outlive their wealth. And rightly so. We estimate that if market returns are poor, this couple would need $1.1 million to maintain their lifestyle for the additional 25 to 30 years they may live.

If the couple gives the $100,000 stock position to charity today, the odds that they will be able to sustain their lifestyle would decline to 84% from 91%, the *display above* shows. That's an outcome that many couples would be unwilling to accept.

If the couple purchases a charitable gift annuity with the $100,000 stock position (Option 1 in the display), the odds that they could maintain their lifestyle would be 90%, almost as good as if they bequeathed the stock at death. They could fulfill their charitable goal today and claim a charitable income tax deduction equal to 31% of their contribution.

The couple could also consider making a smaller direct gift today in conjunction with a slightly smaller charitable gift annuity. Option 2 of the display shows that the couple could donate up to 20% of the stock position today and still have nearly a 90% probability of maintaining their lifestyle. This option would also provide more to the charity up front.

Risk Considerations

A CGA is an irrevocable gift, just like an outright gift of cash. It's important for donors to estimate whether the annuity stream and other assets will cover their expenses.

It's also possible that the charity may be unable to make the payments promised if its financial condition declines. Insurance companies that sell annuities are regulated entities, and their financial strength is evaluated by rating agencies that examine their procedures and reserves. Nonprofit organizations offering CGAs are generally not subject to the same degree of scrutiny.

Charitable Remainder Unitrusts

Best for:	Wealthy individuals and couples with low-basis assets
Benefit:	Tax deferral and avoidance
Tax Impact:	
Limitations:	Deduction subject to AGI limitations on charitable contributions; size of lifetime payouts reflects age of participant
Complexity/Cost:	High; most economical for donations of at least $500,000
Drawbacks:	Irrevocable gift

Charitable remainder unitrusts (CRUTs) generate income for the donor, with the remainder going to charity. They are most often used by charitably inclined taxpayers with large holdings of low-basis stock, because they are a good way to reduce concentration risk and manage the resulting capital gains tax. With the recent rise in the capital gains tax rate and the new net investment income tax, CRUTs are becoming more popular as a way to defer and avoid taxes.

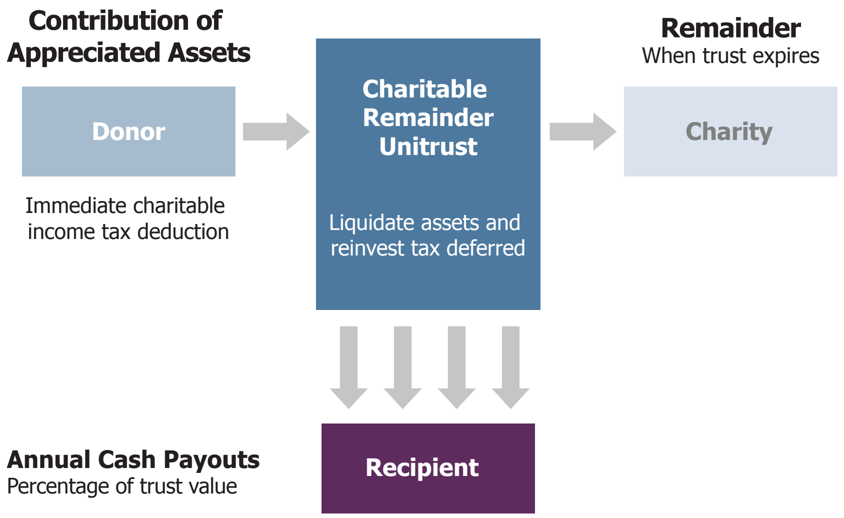
Gifts to a CRUT are irrevocable, so it is imperative to carefully evaluate the strategy in the context of the donor's overall investment plan. The evaluation should include the most tax-efficient assets to contribute, payout rate to set and asset mix.

How a CRUT Works

The structure of a CRUT is straightforward: The donor makes an irrevocable contribution of assets to a trust that typically invests in a diversified portfolio and subsequently distributes taxable payouts equal to a set percentage of the trust's value to the donor or another designated recipient, as the *display below* shows. At the end of the trust term (often the death of the income beneficiary), assets remaining in the trust pass to the charity.

In the year the trust is established, the donor receives a charitable income tax deduction for a portion of the gift. The amount is generally based upon the portion of the trust's initial assets that is likely to go to charity, given the donor's life expectancy or the term of the trust. If a donor contributes a concentrated position of low-basis stock, the

How a Charitable Remainder Unitrust Defers and Avoids Taxes



The income tax deduction is not the total amount contributed but rather the present value of what is expected to pass to charity. The calculation of the present value takes into account the value of the contributed assets, the discount rate (based on the Section 7520 rate) and the term of the trust (for lifetime trusts, a life expectancy table is used). See Sections 7520 and 664 of the Internal Revenue Code of 1986, as amended, and the Treasury regulations thereunder.

Source: IRS and AllianceBernstein

trust typically sells the concentrated position immediately and reinvests the proceeds in a diversified portfolio.

The trust does not pay capital gains tax, but the income beneficiary pays tax on distributions from the CRUT based on how the trust income was earned: interest, dividends, long-term capital gains or short-term capital gains.

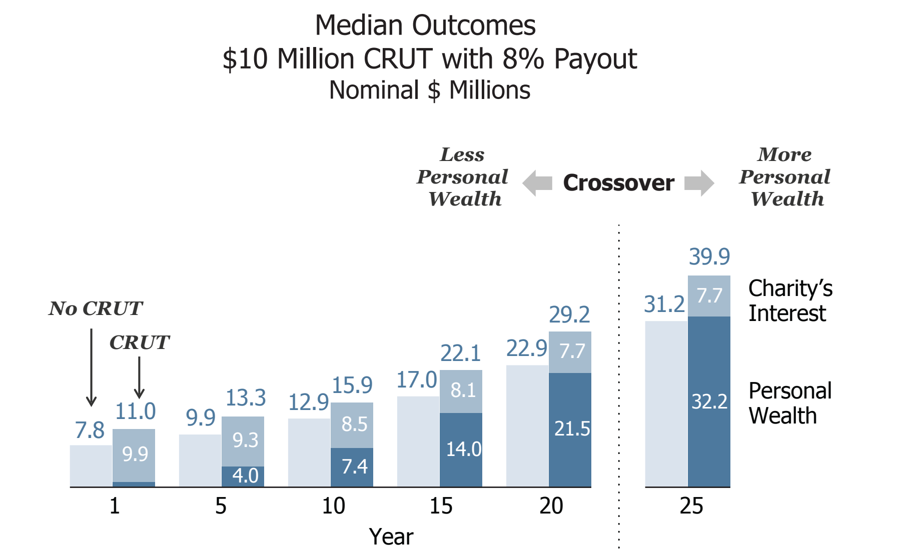
The general IRS rule is that the most highly taxed type of income should come out first. Deferral of the capital gains tax from the trust's sale of the concentrated position can have very favorable financial consequences.

Quantifying the Benefits

The *display at right* shows that the tax benefits of contributing appreciated assets to a CRUT with an 8% payout rate can significantly increase the combined wealth of the donors (for example, a 65-year-old married couple) and the charity. The charity would gain the most if the couple were to die within a few years. But at least one member of a 65-year-old couple is expected to live until age 92. As the years go by, the income distributions could drive up the income recipients' share of the combined wealth.

To evaluate the strategy, we compare simply diversifying the couple's portfolio in a taxable environment without a CRUT with diversifying it within the CRUT. We estimate the accumulated wealth over time—defined as the value of the charitable income tax deduction, the after-tax

Moderate Payout Adds to Donor's Wealth in 25 Years



CRUT based on a 65-year-old couple contributing $10 million in zero-basis assets to a lifetime CRUT with quarterly payouts. Assumes investor is subject to top federal tax rates and state income taxes of 5%. All calculations of permissible payouts and associated tax deductions are according to Sections 7520 and 664 of the Internal Revenue Code of 1986, as amended, and the Treasury regulations thereunder. The CRUT and personal portfolios are allocated 80% to stocks and 20% to bonds.

Based on Bernstein's estimates of the range of long-term returns for the applicable capital markets. See Notes on Wealth Forecasting System for details. ***Data do not represent past performance and are not a promise of actual future results or a range of future results.***

Source: AllianceBernstein

payouts and the wealth generated by reinvesting both of these values—to see the potential range of outcomes.

The display shows the projected median value of the portfolio for sample years, with and without a CRUT. The light blue bar at left is the value of the couple's portfolio if they diversified without a CRUT. The stacked bar at right shows the value of the portfolio with a CRUT, divided between the couple's personal wealth from receiving CRUT payments and the charity's interest.

The display suggests that in the early years, the couple would be better off diversifying outside the CRUT, from a personal wealth perspective: In year five, for example, the couple would have $9.9 million if they didn't have a CRUT, but only $4.0 million in personal wealth with the CRUT (the charity's interest is $9.3 million).

Over time, however, this advantage decreases until "crossover" is reached in 25 years, when the couple would be 90. The portfolio without a CRUT would be worth $31.2 million, while the couple's personal wealth from CRUT payments would be $32.2 million.

From that point on, the couple's after-tax wealth created through the CRUT surpasses the amount they would have had if they had never created a CRUT. For this reason, many wealthy families with appreciated assets find the CRUT strategy attractive. Indeed, the longer the couple lives, the better the CRUT looks from the perspective of personal wealth.

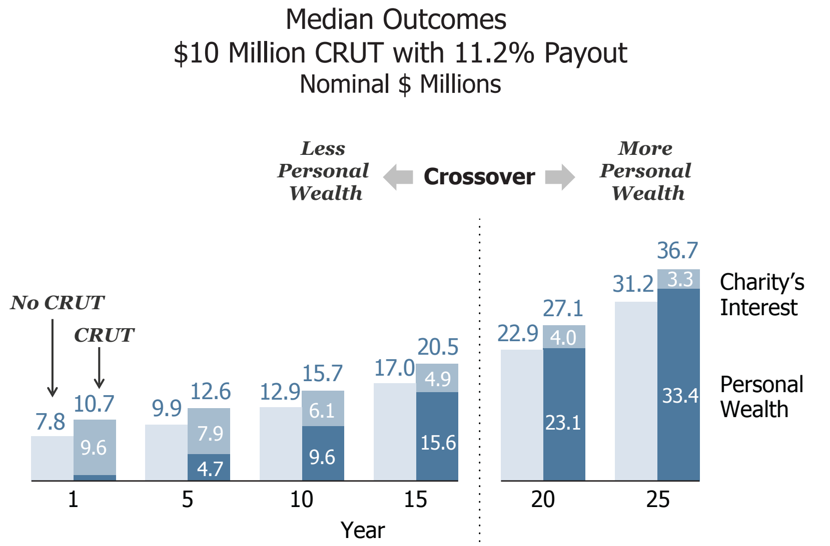
Five factors tend to shorten the time to crossover:

- Larger stock allocations
- Higher income tax rates
- Using the deduction against ordinary income
- Contributing assets with large embedded capital gains
- Higher distribution rates

The *display at right* shows that increasing the payout to 11.2% decreases the size of the charitable income tax deduction, but the larger distributions shift the crossover point to 20 years from 25 years.

Location can also affect the tax benefit, and thus the crossover point. If an investor lives in a state with a high income tax rate when he establishes a CRUT and lives in a state with a low income tax rate, or no income tax at all, when he receives distributions he can permanently avoid state income taxes on the distributions.

High Payout Adds to Donor's Wealth Sooner



CRUT based on a 65-year-old couple contributing $10 million in zero-basis assets to a lifetime CRUT with quarterly payouts. Assumes investor is subject to top federal tax rates and state income taxes of 5%. All calculations of permissible payouts and associated tax deductions are according to Sections 7520 and 664 of the Internal Revenue Code of 1986, as amended, and the Treasury regulations thereunder. The CRUT and personal portfolios are allocated 80% to stocks and 20% to bonds. The exact payout rate is 11.219%.

Based on Bernstein's estimates of the range of long-term returns for the applicable capital markets. See Notes on Wealth Forecasting System for details. ***Data do not represent past performance and are not a promise of actual future results or a range of future results.***

Source: AllianceBernstein

Contributions of collectibles and other highly taxed property would also shorten the time to crossover. There are many variables of CRUTs that require careful analysis.

Risks and Costs

A CRUT can be seen as a form of longevity insurance: a source of perpetual lifetime income for the donor (or other beneficiary). But CRUTs also have some potential drawbacks. While the savings can be meaningful, setting up a CRUT can entail significant costs, as well as ongoing legal and accounting fees. As a result, a CRUT is typically most economical for contributions approaching $500,000 or more.

Some charities offer to serve as cotrustees of CRUTs, which can lower costs to the donor.

Furthermore, payouts from a CRUT are likely to vary from year to year, depending on how the trust assets are invested.

Notes on Wealth Forecasting System

1. Purpose and Description of Wealth Forecasting System

Bernstein's Wealth Forecasting System[SM] is designed to assist investors in making long-term investment decisions regarding their allocation of investments among categories of financial assets. Our planning tool consists of a four-step process: 1) Client Profile Input: the client's asset allocation, income, expenses, cash withdrawals, tax rate, risk-tolerance level, goals, and other factors; 2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as when to retire, what his/her cash-flow stream is likely to be, whether his/her portfolio can beat inflation long term, and how different asset allocations might impact his/her long-term security; 3) The Capital Markets Engine: Our proprietary model, which uses our research and historical data to create a vast range of market returns, takes into account the linkages within and among the capital markets, as well as their unpredictability; and 4) A Probability Distribution of Outcomes: Based on the assets invested pursuant to the stated asset allocation, 90% of the estimated ranges of returns and asset values the client could expect to experience are represented within the range established by the 5th and 95th percentiles on "box and whiskers" graphs. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes.

Expected market returns on bonds are derived taking into account yield and other criteria. An important assumption is that stocks will, over time, outperform long bonds by a reasonable amount, although this is in no way a certainty. Moreover, actual future results may not meet Bernstein's estimates of the range of market returns, as these results are subject to a variety of economic, market, and other variables. Accordingly, the analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.

2. Retirement Vehicles

Each retirement plan is modeled as one of the following vehicles: traditional IRA, 401(k), 403(b), or Roth IRA/401(k). One of the significant differences among these vehicle types is the date at which mandatory distributions commence. For traditional IRA vehicles, mandatory distributions are assumed to commence during the year in which the investor reaches the age of 70½. For 401(k) and 403(b) vehicles, mandatory distributions are assumed to commence at the later of 1) the year in which the investor reaches the age of 70½ or 2) the year in which the investor retires. In the case of a married couple, these dates are based on the date of birth of the older spouse. The minimum mandatory withdrawal is estimated using the Minimum Distribution Incidental Benefit tables as published on www.irs.gov. For Roth IRA/401(k) vehicles, there are no mandatory distributions. Distributions from Roth IRA/401(k) vehicles that exceed principal will be taxed and/or penalized if the distributed assets are less than five years old and the contributor is less than 59½ years old. All Roth 401(k) plans will be rolled into a Roth IRA plan when the investor turns 59½ years old to avoid minimum distribution requirements.

3. Rebalancing

Another important planning assumption is how the asset allocation varies over time. Cash flows and cash generated from portfolio turnover are used to maintain the selected asset allocation between cash, bonds, stocks, REITs, and hedge funds over the period of the analysis. Where this is not sufficient, assets are assumed to be sold to rebalance.

4. Expenses and Spending Plans (Withdrawals)

All results are generally shown after applicable taxes and after anticipated withdrawals and/or additions, unless otherwise noted. Liquidations may result in realized gains or losses, which will have capital gains tax implications.

5. Modeled Asset Classes

The following assets or indexes were used in this analysis to represent the various model classes:

Asset Class	Modeled as...	Annual Turnover Rate
Cash Equivalents	3-month Treasury bills	100%
Intermediate-Term Diversified Municipals	AA-rated diversified municipal bonds of 7-year maturity	30%
Intermediate-Term Taxables	Taxable bonds with maturity of 7 years	30%
US Diversified	S&P 500 Index	15%
US Value	S&P/Barra Value Index	15%
US Growth	S&P/Barra Growth Index	15%
Developed International	MSCI EAFE Unhedged Index	15%
Emerging Markets	MSCI Emerging Markets Index	20%
US SMID	Russell 2500 Index	15%
REITs	FTSE NAREIT Index	30%

6. Volatility

Volatility is a measure of dispersion of expected returns around the average. The greater the volatility, the more likely it is that returns in any one period will be substantially above or below the expected result. The volatility for each asset class used in this analysis is listed in the Capital Markets Projections section at the end of these Notes. In general, two-thirds of the returns will be within one standard deviation. For example, assuming that stocks are expected to return 8.0% on a compounded basis and the volatility of returns on stocks is 17.0%, in any one year it is likely that two-thirds of the projected returns will be between (8.9)% and 28.8%. With intermediate government bonds, if the expected compound return is assumed to be 5.0% and the volatility is assumed to be 6.0%, two-thirds of the outcomes will typically be between (1.1)% and 11.5%. Bernstein's forecast of volatility is based on historical data and incorporates Bernstein's judgment that the volatility of fixed income assets is different for different time periods.

7. Technical Assumptions

Bernstein's Wealth Forecasting System is based on a number of technical assumptions regarding the future behavior of financial markets. Bernstein's Capital Markets Engine is the module responsible for creating simulations of returns in the capital markets. These simulations are based on inputs that summarize the current condition of the capital markets as of December 31, 2013. Therefore, the first 12-month period of simulated returns represents the period from December 31, 2013, through December 31, 2014. A description of these technical assumptions is available on request.

8. Tax Implications

Before making asset allocation decisions, an investor should review with his/her tax advisor the tax liabilities incurred by the different investment alternatives presented herein, including any capital gains that would be incurred as a result of liquidating all or part of his/her portfolio, retirement-plan distributions, investments in municipal or taxable bonds, etc. Bernstein does not provide tax, legal, or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

9. Tax Rates

Bernstein's Wealth Forecasting System uses the federal tax rates in the table on page 6. Federal tax rates are blended with applicable state tax rates by including, among other things, federal deductions for state income and capital gains taxes. The state tax rate generally represents Bernstein's estimate of the top marginal rate, if applicable.

10. Charitable Remainder Trust

The Charitable Remainder Trust (CRT) is modeled as a tax-planning or estate-planning vehicle, which makes an annual payout to the recipient(s) specified by the grantor, and at the end of its term (which may be the recipient's lifetime) transfers any remaining assets, as a tax-free gift, to a charitable organization. Depending on the payout's structure, the CRT can be modeled as either a Charitable Remainder Unitrust (CRUT) or a Charitable Remainder Annuity Trust (CRAT). The CRUT's payout is equal to a fixed percentage of the portfolio's beginning-year value, whereas the CRAT's payout consists of a fixed dollar amount. In the inception year of the CRT, its grantor receives an income tax deduction typically equal to the present value of the charitable donation, subject to the applicable Adjusted Gross Income (AGI) limits on charitable deductions and phaseout of itemized deductions, as well as the rules regarding reduction to basis of gifts to private foundations. Unused charitable deductions are carried forward up to five years. Although the CRT does not pay taxes on its income or capital gains, its payouts are included in the recipient's AGI using the following four accounting tiers: Tier 1: Ordinary Income (Taxable Interest/Dividends); Tier 2: Realized Long-Term Capital Gains; Tier 3: Other Income (Tax-Exempt Interest); and Tier 4: Principal. CRTs are required to pay out all current and previously retained Tier 1 income first, all current and previously retained Tier 2 income next, all current and previously retained Tier 3 income next, and Tier 4 income last.

11. Capital Markets Projections

	Median 45-Year Growth Rate*	Mean Annual Return*	Mean Annual Income*	One-Year Volatility	45-Year Annual Equivalent Volatility
Cash Equivalents	3.7%	4.1%	4.1%	0.0%	13.3%
Intermediate-Term Diversified Municipals	4.0	4.3	3.9	3.1	10.5
Intermediate-Term Taxables	5.1	5.5	6.4	3.9	12.1
US Diversified	7.8	9.6	3.1	16.4	23.0
US Value	8.1	9.7	3.7	16.0	22.6
US Growth	7.5	9.6	2.5	18.2	24.4
US SMID	7.9	10.0	2.8	18.7	25.1
Developed International	8.3	10.5	3.4	18.1	23.6
Emerging Markets	6.7	10.7	4.3	26.2	30.8
REITs	7.6	9.3	5.2	16.9	20.1
Inflation	3.2	3.5	n/a	0.9	11.9

*Based on 10,000 simulated trials each consisting of 45-year periods. Reflects Bernstein's estimates and the capital-market conditions as of December 31, 2013.

Does not represent any past performance and is not a guarantee of any future specific risk levels or returns, or any specific range of risk levels or returns.

Disclosure on Security Examples

References to specific securities are presented to illustrate the application of our investment philosophy only and are not to be considered recommendations by AllianceBernstein.

How **Bernstein Research** Can Work for You

Bernstein works with investors and their tax advisors to quantify the potential impact on after-tax wealth and income of strategies like those discussed in this playbook. We take the investor's unique circumstances and goals into account. We design and implement strategies, too.

Call your Bernstein Advisor.
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