Tax Defaults and Calculations

MoneyGuidePro® makes default tax assumptions for both the pre-retirement and post-retirement periods. You can change the defaults within the Financial Goal Plan by clicking About You > Personal > Personal > Edit under Tax & Inflation Options or Results > Recommended Scenario > What If Worksheet > Tax & Inflation Options at the bottom of the page.

Tax Rates Before Retirement

Prior to retirement, taxes are paid annually on a percentage of the earnings from taxable accounts. MoneyGuidePro® uses marginal tax rates prior to retirement because the Program is calculating taxes only on investment earnings, Goals funded from pre-tax funds, and RMDs. Employment income and the expenses paid with employment income (including taxes on employment income) are not factored into the Program pre-retirement; therefore, the Program solely concerned with the rate used on the next dollar of income. MoneyGuidePro® uses the clients’ income, marital status and current state of residence to default the marginal federal and state tax rates. If the clients are subject to a local tax rate, you should enter it on the Tax and Inflation Options page. You can also change the pre-retirement federal and state tax rates for up to three different periods. When calculating taxes, MoneyGuidePro® first calculates state and local taxes, and then calculates federal taxes.

Tax Rates During Retirement

In MoneyGuidePro® tax calculations, Retirement begins for a couple when they are both retired. The MoneyGuidePro® default for tax calculations during retirement is to let the Program calculate taxes each year. We first calculate the state taxes (local taxes are included if entered), and then we calculate federal taxes. The Program calculates federal and state taxes each year using progressive tax tables and the appropriate LTCG rate. By default, the Program uses the standard deduction based upon the clients’ marital status and age for tax calculations. As mentioned earlier, this tends to overestimate, rather than underestimate, taxes. During retirement, you may change the federal and state tax deductions to your own estimated amounts for two different periods in retirement. By entering your own deduction estimate, the Program will implement the state and local tax (SALT) deduction. Therefore, federal taxable income will be reduced by state taxes paid (up to $10,000). You also have the option of using a fixed average tax rate. If you use a fixed average tax rate, this rate will apply to every dollar of ordinary income (LTCG will still be calculated). Also, there will not be any deductions applied in the calculation.

Untaxed Gain on Taxable Earnings

This section allows you to specify the percentage of annual taxable earnings not taxed until withdrawn. The default is 0%, meaning all earnings from taxable investments will be taxed in the year earned.

MoneyGuidePro® uses assets in a prescribed order to fund Goals and pay taxes (see the Spending Order section below for details). When untaxed gains on taxable assets are used to pay expenses, taxes are due on the deferred appreciation (the difference between the current value and the cost basis). Tax-deferred and qualified assets also generate taxes when money is withdrawn to pay for Goals.
**Long-Term Capital Gains**

Long-term capital gains (LTCG) apply only to earnings and withdrawals from taxable investments. For both investment earnings (earnings from the portfolio) and any realized gains (deferred earnings realized when used to fund a goal expense), a portion of the gain will be taxed at the LTCG rate, and the remainder will be taxed at the ordinary income rate.

Prior to retirement, the Program, by default, taxes 20% of taxable investment gains as long-term capital gains and 80% as ordinary income. This is a reasonable, conservative average for clients who have a mix of taxable investments generating interest, dividends, short-term and long-term capital gains. You can change this percentage to better match a client’s specific situation for each Plan if desired.

Pre-retirement, the Program will make an estimate for the LTCG rate, but you are also able to override this rate for each Plan. During retirement, the Program will calculate LTCG taxes due automatically when you are letting the Program calculate taxes; therefore, you will not be able to override the LTCG rate used. If you use a fixed average tax rate, you can enter your own rate estimate.

Remember, increasing the LTCG percentage decreases the total taxes, because a higher percentage of gains are taxed at the lower LTCG rate. We believe it is usually preferable to overestimate, rather than underestimate, taxes.

**Taxation of Social Security**

By default, MoneyGuidePro® taxes 85% of a client’s Social Security. The portion of Social Security subject to income tax can vary based on annual adjusted gross income; therefore, we use the maximum as a conservative default estimate. The portion can be changed in this section based on the client’s situation.

**Tax Penalties**

By default, the Program includes tax penalties on withdrawals made from tax-deferred or qualified assets before the owner reaches age 59½. You can choose to exclude tax penalties, which will remove all tax penalties from all applicable scenarios within the Plan. As with other taxes, the tax penalty is paid by grossing up the amount needed to include the taxes and penalties. The option chosen in the Tax and Inflation Options affects the Current Scenario only; this option can be changed for a What if Scenarios on the What if Worksheet.

**Tax-Free Options**

This option allows you to specify if tax-free assets (i.e. municipal bonds) will be treated as tax-free or taxable assets. This will change both the return assumption and the tax treatment of these assets.
### Spending Order for Assets

<table>
<thead>
<tr>
<th>1. Reliable Income</th>
<th>12. Roth for co-client without penalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Cash Reserve</td>
<td>13. Inherited Traditional IRA for client</td>
</tr>
<tr>
<td>3. 529 Savings Plans</td>
<td>14. Inherited Traditional IRA for co-client</td>
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<tr>
<td>4. Coverdell Education Savings Accounts (CESAs)</td>
<td>15. Qualified for client without penalty</td>
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<tr>
<td>5. Taxable</td>
<td>16. Qualified for co-client without penalty</td>
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<tr>
<td>6. Tax-free</td>
<td>17. Tax-deferred for client with penalty</td>
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<tr>
<td>7. Tax-deferred for client without penalty</td>
<td>18. Tax-deferred for co-client with penalty</td>
</tr>
<tr>
<td>8. Tax-deferred for co-client without penalty</td>
<td>19. Roth for client with penalty</td>
</tr>
<tr>
<td>9. Inherited Roth for client</td>
<td>20. Roth for co-client with penalty</td>
</tr>
<tr>
<td>10. Inherited Roth for co-client</td>
<td>21. Qualified for client with penalty</td>
</tr>
<tr>
<td>11. Roth for client without penalty</td>
<td>22. Qualified for co-client with penalty</td>
</tr>
</tbody>
</table>

The first five items in the Spending Order (Reliable Income, Cash Reserve, 529 Savings Plans, CESAs, and Taxable) are fixed and cannot be changed. The remaining items can be reordered. If you want to change this default for all of your clients, you can do so by clicking **Main Menu > User Options > Financial Goals Options > Spending Order Default**. If you want to change the Spending Order for any scenario in a client’s Plan, you can do so in the Spending Order section of the What If Worksheet by clicking **Results > Recommended Scenario > What if Worksheet > Change Assumptions** under the Spending Order section.

### Using the What If Scenarios for Tax Sensitivity Analysis

None of us can predict actual tax rates or tax brackets in the future. The best we can do is to make reasonable assumptions. You can use the What If Scenarios to see how your clients’ Probability of Success might be affected by increases or decreases in tax rates for a specified period of your Plan. If you make any changes to the Tax Options section at the bottom of the What if Worksheet, MoneyGuidePro® will increase or decrease both the federal and state tax rate by the percentage specified, starting the year specified through the end of the Plan. Taxes cannot be increased or decreased by more than 50%. As previously mentioned, you can also change whether or not tax penalties are included in a What if Scenario in this section.

### Tax Credits, Itemized Deductions, and Alternative Minimum Tax

We do not include detailed tax estimates beyond what is described in the paragraphs above.

Our design philosophy focuses on reasonable estimates given assumptions that can be reasonably predicted. We do not believe it is possible to accurately predict certain tax assumptions for twenty, thirty, or forty years in the future (e.g., depreciation, tax credits, itemized deductions, and alternative minimum taxes). We believe the assumption someone can predict taxes at this level of detail far into the future is a presumption of an unrealistic level of precision.
Other User Guides of Interest

- “Planning Philosophy of MoneyGuidePro®” – covers our unique Philosophy, including why we use marginal tax rates before retirement.

MoneyGuidePro.com
800.743.7092

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