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Charitable Giving 101

With the passing of the Tax Cuts and Jobs Act (TCJA), many deductions and credits were substantially limited, if not eliminated outright. However, one significant deduction that remains for individuals who itemize their deductions is the deduction for charitable contributions.

This article will examine a few ideas on how to effectively plan charitable activity depending on the size and scope of an individual's charitable aspirations.

Charitable Deduction Limitations

For tax years beginning prior to 2018, the deductibility of cash contributions made to public charities and private operating foundations was limited to 50% of the taxpayer's adjusted gross income (AGI). The TCJA expands this limitation to 60% of AGI (provided only cash gifts are given in a calendar year). Cash gifts to private foundations

remain limited to 30% of AGI. As under prior law, deductions of long-term appreciated property are limited to 30% of AGI for contributions to public charities and private operating foundations while contributions to private non-operating foundations are limited to 20% of AGI. Also as under prior law, noncash contributions to private non-operating foundations are generally limited to the donor's adjusted basis in the property, though most contributions of qualified publicly traded stock are eligible for a fair market value deduction. With this backdrop, below are specifics relating to some of the types of entities a taxpayer can contribute to.

Creating a Private Non-Operating Foundation

Private non-operating foundations generally function as grant-giving organizations. Present-year contributions to a private non-operating foundation will result in a present-year tax deduction to the donor, though the contributions may be used by the foundation to fund several future years of charitable giving. Five percent of a private non-operating foundation's average investment assets must be distributed annually in the form of grants and charitable expenditures, otherwise the foundation must pay an excise tax.

Investment income generated by the assets of a private foundation is subject to a tax rate of 1% or 2%, depending on how much has been distributed out of the foundation. Activities of private foundations are also subject to several prohibitions, such as those against self-dealing, jeopardizing investments, and excess business holdings (although under new law, in certain circumstances these business holdings are permitted). As there are no public support requirements, private foundations are generally funded by a small pool of donors, often limited to the donor and his or her family. A private foundation has the option to make charitable grants to foreign charities or even non-charities when exercising appropriate expenditure responsibility over the grant.

Private foundations can help create a legacy of organized charitable giving within a family, as founders will often appoint their own family members and children to serve on the board of the private foundation. Generally, private foundations are vehicles best used for individual making significant charitable contributions, either during their lives or at death.

Contributing to a Donor Advised Fund

A donor advised fund (DAF) is a special fund or account held within a public charity. Donations to a DAF are subject to the same AGI limitations and eligible for most of the benefits that come from giving to public charities. Assets donated to a DAF are under the control of the public charity housing the fund, which takes care of all administrative work regarding grant giving from the DAF. Present-year contributions to a DAF yield present-year income tax deductions, however, unlike a private non-operating foundation, a DAF is not legally required to distribute any minimum amounts to outside charities annually, and therefore charitable distributions from the DAF can be spread out over many years.

One of the main downsides to a DAF is the lack of ultimate control that a donor has over the donated assets. While a donor can advise the DAF on how the donations should be distributed to charities, the DAF is under no legal obligation to follow the donor's requests. In all practicality, the DAF will generally follow a donor's requests, but each DAF has their own set of internal guidelines, and some may require that distributions are only made to domestic public charities among other limitations. In addition, donors also have less control over investments in the DAF and investment choices are limited to the offerings of the charity housing fund.

DAFs have their own unique fee structure, usually consisting of one-time start-up fees and recurring fees charged as a percentage of assets held by the DAF. Because all the administrative work relating to DAFs is handled by the

charity housing the fund, they are generally significantly less expensive and administratively burdensome than a private foundation.

Creating a Public Charity

For those pursuing a more hands-on charitable mission, including direct charitable activity and solicitation from the public, creating a public charity is also an option. While there are still limits on activities that can be conducted within a public charity, the stricter prohibitions against self-dealing, jeopardizing investments and excess business holdings that apply to private foundations do not apply to public charities. Also, a public charity does not pay the 1% or 2% excise tax on its investment income. Importantly, unless the entity engages in an inherently public activity (religious, educational, medical, etc.), one third of a public charity's annual support is generally required to be derived from the general public.

From a privacy perspective, public charities are not required to publicly disclose the names and addresses of donors, creating a level of anonymity for donors. This is unlike the requirements for private foundations, which must publicly disclose these names.

As a broad range of public support is necessary to maintain public charity status, starting a public charity is only an option for individuals who intend to solicit from or otherwise receive a significant amount of contributions from the general public.

Creating a Private Operating Foundation

Similar to a public charity, private operating foundations carry on their own charitable programming and operate beyond the scope of grant giving. However, they are typically funded by one or a few donors with little to no public support. Public charity benefits such as the 60% and 30% AGI limitations for cash and noncash gifts, as well as fair market value deduction for noncash gifts are extended to private operating foundations.

Private operating foundations pay the same 1% or 2% tax on investment income that applies to non-operating private foundations and the same prohibitions against self-dealing, jeopardizing investments and excess business holdings also apply. A private operating foundation also has its own set of distribution requirements. A private operating foundation must spend at least 85% of its net income directly for the active conduct of its own charitable activities and programming, in addition to other requirements.

A private operating foundation is a good fit for individuals who would like to conduct their own charitable activities and programming, but who lack the broad base of public support necessary to gain status as a public charity.

The Takeaway

Charitable contributions can require a significant degree of planning depending on the structure and range of the anticipated donation. There are multiple roads to maximize a taxpayer's charitable goals, and it is important to explore all options to ensure the optimum route.

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The Impact of Tax Reform on Employer-Provided Fringe Benefits

The Tax Cuts and Jobs Act (TCJA) made significant changes to the tax deductibility of certain fringe benefits provided to employees.

As a result, companies should assess their current policies to determine if a change in their business expense policies is necessary. Certain system changes may also be necessary to segregate deductible and non-deductible items. The following discussion addresses some of the new rules applicable to employer-provided fringe benefits as implemented by the TCJA.

Meals and Entertainment

Before the TCJA, generally 50% of meal and entertainment expenses were deductible under Sec. 274 as long as they were ordinary, necessary and directly related to the employer's trade or business. Certain expenses, such as

qualified employee recreation, tickets to qualified charitable events and qualified de minimis meals, were fully deductible if certain conditions were met.

For expenses paid or incurred on or after January 1, 2018, the rules regarding meals and entertainment have significantly changed. Expenses incurred for entertainment may no longer be deductible and only 50% of meals are deductible unless they fall under specific exceptions set forth in Sec. 274(e).

- **Qualified Employee Recreation** – Expenses for qualified employee recreation (e.g., office holiday parties or summer picnics) continue to be fully deductible when provided primarily for the benefit of employees other than officers, shareholders/other owners who own a 10% or greater interest, or highly compensated employees.
- **Entertainment** – The TCJA repeals the prior deduction for entertainment, amusement, or recreation expenses directly related to the active conduct of the taxpayer's trade or business. Under prior law, 50% of these expenses were deductible. This includes expenses for theater tickets, sporting events, golf and athletic clubs, and country clubs. Food and beverages provided during entertainment events will not be considered entertainment if purchased separately from the event, or stated separately on a bill, invoice or receipt.
- **Business Meals** – Fifty percent of business meals (e.g., employee travel meals or client meals) remain deductible if: 1) the meals are not lavish or extravagant under the circumstances, and 2) the taxpayer (or an employee of the taxpayer) is present during the meals. The meals may be provided to a current or potential business customer, client, consultant or similar business contact.
- **Meals Provided for Convenience of the Employer** – On-premises meals that are considered de minimis fringe benefits (the value and frequency with which they are provided is so small as to make accounting for them unreasonable or impractical) or are provided for the convenience of the employer are no longer fully deductible. Instead, there is a 50% deduction for such meals if they are provided for a substantial non-compensatory business reason, as defined in Reg. 1.119-1(a)(2). The employer's business policy for providing the meals is relevant in determining if a substantial non-compensatory business reason exists for the deduction. The employer should ideally have their business policy in writing.
- **Expenses Treated as Compensation** – Meals and entertainment expenses treated by the taxpayer as compensation paid to an employee are fully deductible under Sec. 274(e)(2). For example, an employer who treats an employee to an expense-paid trip as a reward can deduct the expense to the extent the employer treats the expense as compensation and wages paid to the employee.

Transportation

Section 132(f) provides employees an exclusion from gross income for qualified transportation fringe benefits provided by an employer. Qualified transportation fringe benefits include qualified parking (at or near the employer's premises or a location from which the employee commutes to work by public transit), transit passes, vanpool benefits and qualified bicycle commuting reimbursements. Under pre-TCJA law, these benefits were also deductible by the employer as employee compensation.

The TCJA eliminated the employer deduction for 1) qualified transportation fringe benefits, and 2) any expense, or any payment or reimbursement, incurred in providing transportation between the employee's residence and place of employment, except as necessary for the safety of an employee. Employees are generally still entitled to exclude qualified transportation fringe benefits from income; however under the new law the exclusion for qualified bicycle commuting reimbursements (up to $20 per month) is eliminated.

Moving Expenses

Under prior law, individual taxpayers could deduct the reasonable cost of moving, along with travel costs of moving to a new home under Sec. 217, provided the following requirements were met:

- Employers did not pay or reimburse the moving costs and exclude the payment or reimbursement from taxpayer's income;
- The new work location was a certain distance from the former home; and
- The expenses were closely related in time to the start of work at the new location.

There was also a related income exclusion under Sec. 132(g) for qualified moving expense reimbursements paid by an employer.

Under the TCJA, the deduction and related exclusion for qualified moving expense reimbursements is eliminated for most taxpayers. There is a limited exception for active military. In addition, to the extent an employer reimburses an employee for moving expenses, that reimbursement is treated as taxable compensation. Note however, if a taxpayer moved in 2017 but was reimbursed by their employer in 2018, there is no tax on such reimbursement.

The Takeaway

To account for the changes discussed above, companies need to review their benefit programs and evaluate their internal accounting procedures for these expenditures. Where items are no longer deductible or where the deduction is limited, adjustments will be required to compute taxable income. Consideration should be given to the treatment of fringe benefits under state and local laws as well.

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FASB ASC Topic 842, Leases – What You Need to Know About the Incremental Borrowing Rate

One of the hot topics in the accounting world is the implementation of Accounting Standards Codification (ASC) Topic 842, Leases, which replaces ASC Topic 840 and is published by the Financial Accounting Standards Board (FASB).

Under the new rules, public companies are required to adopt this new standard for annual reporting periods beginning after December 15, 2018, with private entities adopting the standard one year later. The main effect of ASC Topic 842 is to require companies to capitalize all operating lease obligations that exceed 12 months, and book a corresponding lease liability. Both the capitalized asset (the Right of Use Asset) and the liability involve present valuing the future lease payments using an appropriate discount rate, in most cases the incremental borrowing rate (IBR). Technically, a company should rely on the interest rate implicit in the lease to determine the appropriate

discount rate. However, this rate is generally indeterminable and requires knowledge of the fair value of the leased asset. In practical terms, companies will almost always rely on their IBR. As a result, the selected IBR can have a significant impact on a company's balance sheet.

What Is the IBR?

ASC Topic 842 defines the IBR as:

The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.

Under the old rules (ASC Topic 840), the IBR corresponded to the rate associated with financing the purchase of the leased asset. The definition did not specify that the rate had to be secured and it took into account property-specific considerations. Generally, the definition of IBR under ASC Topic 842 results in a lower discount rate than under ASC Topic 840.

Below are the characteristics of the IBR:

1. **Collateralized** – Whereas the old definition did not specify whether the discount rate needed to reflect collateralization, the new definition specifies a secured rate, which reflects full collateralization, but not over- or under-collateralization. For this hypothetical borrowing, the lessee could use as collateral any asset it holds that is at least as liquid as the underlying asset. Since the lessee does not own the underlying asset, it could not use that asset as collateral.
2. **Similar term** – The term associated with the hypothetical borrowing and IBR should correspond to a period comparable to the lease term.
3. **Similar economic environment** – To the extent that market indications obtained by a hypothetical company (the Company) reflect loans initiated as of a different date than the measurement date, or the lease was executed in a foreign country, the Company will need to make adjustments to the obtained rate to calculate the applicable IBR.

Key Steps in Determining the IBR:

1. Start with the Company's existing debt facilities.

    - If the Company has a secured line of credit, it may serve as an indication for the Company's IBR. However, the Company should consider whether adjustments need to be made for any changes in the economic environment or to reflect the appropriate amount of collateralization.
    - If the Company has an unsecured loan, start with the interest rate and adjust downward to obtain a secured rate. Also, adjust for any changes in the economic environment or term.

2. If the Company does not have any comparable debt facilities, the Company must look to market indications.

a. Unless comparable secured rates are available, start with a general, unsecured recourse borrowing rate for loans with:

- A similar term;

- Initiated in a similar interest rate environment;
- Located in a similar geography; and
- Reflecting the Company's credit rating.

b. Adjust the rate for effects of full collateralization.

Paragraph 842-20-30-3 of ASC Topic 842 provides a practical expedient for private companies, which allows them to use a risk-free rate, rather than an IBR, to calculate the Right of Use Asset and lease liability. Since the risk-free rate is lower than the IBR, this expedient would result in higher values for both the asset and liability. For public companies, the selection of an appropriate IBR for a Company can also have a significant impact on its balance sheet.

Below is an example related to quantifying the lease liability using three different rates. Note that the calculation of the Right of Use Asset starts with the value of the liability and makes certain modifications for prepayments, direct costs and/or lease incentives. Assuming a five-year lease with annual lease payments of $1 million, the implied lease liability would be as follows:

Rate	2.5% risk-free rate	5.0% IBR	7.5% IBR
Lease Liability	$4,645,829	$4,329,477	$4,045,885

In this example, the difference between using a 5.0% and a 7.5% IBR can result in a $284,000 difference in the liability.

The Takeaway

Companies should work closely with their auditors to ensure that they are properly implementing the new lease standard, and in many cases will need to employ third-party valuation or other specialists to help them determine their company's IBR. Additionally, companies will also need to work with their tax advisors; although ASC Topic 842 will not impact how leases are treated for U.S. federal income tax purposes, it may impact U.S. tax accounting methods, deferred tax accounting, and state taxes, among other areas.

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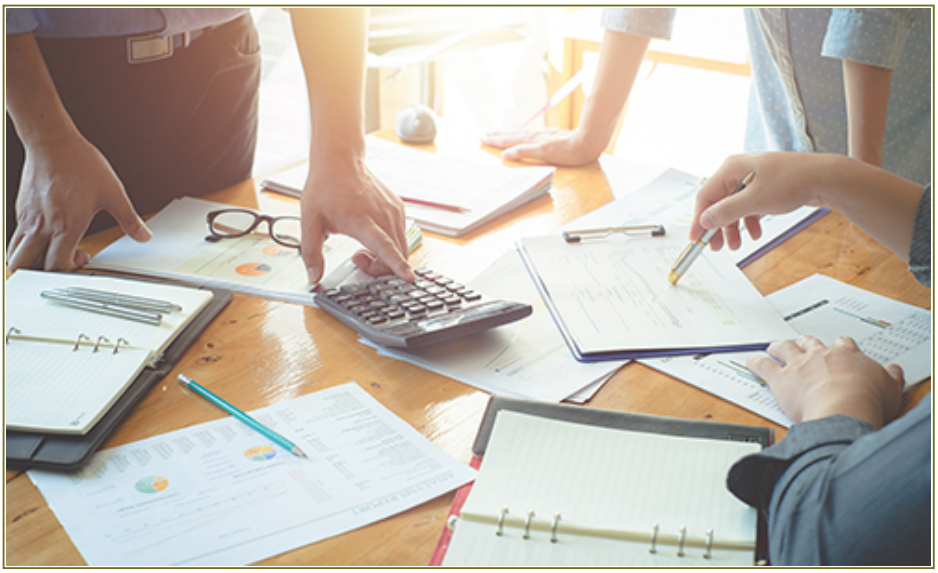
Tax Reform Update: Cost Segregation and New Interest Limitation Rules



Cost segregation has long benefited taxpayers with increased cash flow and long-term net present value benefits by reclassifying building or improvement costs to property with shorter tax lives, such as personal property or land improvement property.

We discussed cost segregation benefits in light of tax reform in a prior issue of For the Record (see Cost Segregation Benefits from the Recent Tax Reform Act). In this tax reform update, we discuss how cost segregation continues to add value in light of recent changes to the regulations under Sec. 163(j) and the new interest expense limitation rules.

Background

The Tax Cuts and Jobs Act (TCJA) includes cost recovery provisions that creates new tax planning and savings opportunities for taxpayers owning or operating real estate. Portions of the TCJA directly benefit cost segregation studies (CSS); including 100% bonus depreciation for qualifying property acquired and placed in service after September 27, 2017, as well as an expansion of the definition of qualifying property to include used property (i.e., there is no longer an original use requirement).

However, since the TCJA has passed, taxpayers and their advisors have been left with uncertainty on many topics that are expected to be addressed in future technical corrections or other administrative guidance. Qualified Improvement Property (QIP), for instance, was expected to have a 15-year recovery period (20 years under the alternative depreciation system (ADS)) and be eligible for bonus depreciation. However, QIP is currently a 39-year asset (40-year ADS) that is ineligible for bonus depreciation.

Other uncertainties surround Sec. 163(j), which relates to the deduction of business interest expense when a taxpayer is an electing trade or business. Despite these uncertainties, a CSS remains beneficial in light of changes made to Sec. 163(j) for real estate trades or businesses.

Section 163(j) Interest Expense Limitation

The TCJA amended Sec. 163(j) to apply new rules that limit the ability of taxpayers to deduct business interest expense for tax years beginning after 2017. The new limitation is generally applicable to all taxpayers with business interest expense. However Section 163(j) does however allow qualifying real estate trades or farming businesses to elect to be excluded from the limitation. If an election is made, electing taxpayers must use ADS tax lives for residential and commercial property, as well as QIP. The provision as amended also states that electing taxpayers are not eligible for bonus depreciation provided under Sec. 168(k). This ineligibility for bonus depreciation, however, does not apply to assets typically reclassified from a CSS, such as personal property or land improvements. An exception to this is specific to electing farming businesses, where property with an ADS recovery period of 10 years or more is not eligible for bonus depreciation. Thus, electing and non-electing taxpayers can continue to benefit from cost segregation. Since it is only real property that is affected by Sec. 163(j), shorter-lived property or land improvements are not required to use ADS and can still take bonus depreciation.

Qualified Improvement Property

Under the TCJA, QIP now captures all property formerly known as qualified leasehold improvements, qualified retail improvement property or qualified restaurant property (collectively, Qualified Property). QIP is essentially any improvement to the interior of a building. Prior to the TCJA, QIP and Qualified Property were eligible for bonus depreciation. However, Congress' intent to amend Sec. 168(e)(3) to assign a 15-year recovery period (20-years ADS) to QIP was overlooked. Consequently, QIP currently does not qualify for the new 100% bonus depreciation or a 15-year recovery period. Electing taxpayers can still benefit from a 20-year ADS life for QIP, rather than a 40-year life, though they would not be eligible for bonus depreciation.

The Takeaway

As currently enacted, property with an ADS class life of 20 years or less (e.g., personal property and land improvements) is eligible for bonus depreciation, regardless of whether a taxpayer is subject to amended Sec. 163(j) or elects to be excluded as a qualified real estate trade or business. This can provide a significant benefit for taxpayers constructing or acquiring commercial or residential real estate.

As a result, cost segregation remains beneficial for real estate trades or businesses electing to be excluded under amended Sec. 163(j), though proper planning should be considered for taxpayers whose renovation costs include QIP. Taxpayers should also consider the impact if a retroactive technical correction is made by Congress to treat QIP as 20-year ADS property.

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Structuring a Carried Interest

A common practice in alternative investment funds, such as private equity and hedge funds and even some family offices, is to grant the managing partner an interest in the profits of the fund.

Unlike management fees, which are a flat fee paid regardless of performance and taxed as ordinary income, an interest in profits incentivizes the general partner (GP) to maximize long-term profits of the fund. Known as a carried interest, that interest in profits allows the GP to both be rewarded for the fund's successes as well as get the benefit of preferential tax rates from any long-term capital gain and qualified dividends generated by the fund. GPs often raise questions as to whether it is required under tax law (and not simply the partnership agreement and specific economic deals with investors) to invest personal capital in order to get the benefit of those rates rather than being subject to ordinary income tax rates for their services.

Analysis

There is no code section mandating a particular form for a carried interest. A partnership agreement is effectively a contract between partners in a fund, and, if the agreement specifies that one or more partners receive an allocation of profits, IRS will honor that allocation even if the profits interest is not accompanied by a capital interest. In other words, the presence or absence of a capital interest will not by itself change the character of income allocated through a profits interest. Relevant IRS guidance does not require any capital to be contributed in exchange for a profits interest and, in fact, assumes no capital is actually contributed. Nonetheless, attorneys will often advise that the GP make a capital commitment. The simple reason is so the GP will be recognized as a partner in the fund on day one.

As an example, assume the GP and the limited partner (LP) invest in a limited partnership (the Fund). The LP invests $100, the GP invests $0, and the partnership agreement says that the LP will receive its capital commitment back, plus $10 (the preferred return). Thereafter profits will be split 80% to the LP and 20% to the GP. If, in Year 1, there is profit of $20, the first $10 is allocated to the LP for the preferred return, and the remaining $10 is allocated $8 to the LP and $2 to the GP. Capital accounts at the end of the year are $118 for the LP and $2 for the GP.

Alternatively, if in Year 1 there is only profit of $5, it does not exceed the preferred return and is allocated 100% to the LP. Capital accounts at the end of the year are $105 for the LP and $0 for the GP. The perceived risk in this scenario is that IRS may determine that with no capital account, the GP is not a partner in the Fund on day one. If the LP is the only partner, the Fund is instead a single-member disregarded entity (DRE) for tax purposes.

There are several consequences to IRS deeming the Fund a DRE. Because as a DRE, the Fund would not be allowed to file a partnership tax return, all activity would have to be reported on the LP's tax return. If IRS makes the determination after the Fund already filed several years of tax returns, from an administrative standpoint, it could require numerous amended returns for the LP. From a tax perspective, this reclassification could possibly void certain elections and render some expenses nondeductible, particularly under the tax rules.

There is also a risk that IRS would disagree as to when the GP's interest vests. There is a principle in partnership law that states that if a partner receives a partnership interest with value in exchange for services, the partner will be taxed on the value of that interest at ordinary rates. The industry practice is that a carried interest has no inherent value until the GP's interest vests, so there is nothing to tax. Once the GP's interest vests, the value of the GP's capital account is based entirely on income allocations from the fund. Those income allocations are taxable on their own under the same rules as a partner with contributed capital, so there is no value deemed granted to the partner in exchange for services.

Based on the partnership agreement, this capital shift should not occur because the GP's interest would vest immediately upon the capital account becoming a non-zero amount. If profit is $10, the GP receives no allocation of income and therefore has no capital account. If profit is $11, the GP's interest vests and it receives an allocation of income of 20 cents. The GP's capital account is only 20 cents, all of which is from an allocation of income, so the GP received no taxable shift of capital.

There is always the possibility, though, that IRS may wrongly determine that the carried interest vests at an arbitrary time. At the end of the first taxable year that the carry vests, for instance, or at the end of a particular transaction that causes the value of the Fund to exceed the preferred return. If the $20 of profit is a single transaction, the GP will argue that their interest vests during the transaction and it should receive $2 of taxable income. IRS, though, may argue that the GP's interest vests at the close of the transaction. At the close of the

transaction the GP's interest is worth $2, and if the GP doesn't receive that $2 as an allocation of income, the IRS may argue it's a taxable shift and the $2 is taxable at ordinary rates **as compensation for services rather than as an allocation of profit**. Even if the GP would prevail at trial, the cost of litigation may be prohibitive.

The Takeaway

As a protective measure, the partnership agreement should specify that the GP is treated as an owner of a partnership interest for tax and all other purposes as of the date of the grant of the carried interest, irrespective of the presence of a capital interest. The GP should also file a protective Sec. 83(b) election to mitigate the consequences of the IRS imposing an arbitrary time of vesting.

Unless a law firm advises that the GP will be treated for state law purposes as a partner or member on the date of grant, if there is a risk that the GP may not receive any regular distributions or allocation of profits in the first year of a partnership, the GP should consider making a contribution of the lesser of 0.1% of total capital in the fund or $100,000 to obtain an immediate capital interest. This capital interest ensures that the GP is a partner on day one. If the GP is itself a partnership with multiple partners, each partner in the GP entity does not need to separately contribute the lesser of 0.1% of total capital in the fund or $100,000. The GP contribution can be split amongst the partners in the GP, or even borne only by specific partners.

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Protect Your Portfolio (From Yourself)

History demonstrates that chasing hot stocks, trying to time the market, or both, are great ways for investors to fall short of their retirement goals.

Typically accompanying and compounding these errors are emotions like greed or fear. More often than not, it's these behaviors rather than a poor investment strategy that undermines investor's returns.

The question then becomes: how do investors block out these natural human emotions? Perhaps the best way to avoid these pitfalls is to develop a strategy that includes the following:

1. Focus on what can be controlled,
2. Establish a personal required rate of return (RoR), and
3. Perhaps most important, learn to recognize (and ignore) natural cognitive biases.

What Can Be Controlled?

No matter how much one may think they can predict the direction of the market, it is often a fool's errand. Instead, isolate the factors that are most easily controlled and re-focus energies there:

- **Risk/Volatility:** Risks can be managed through asset allocation. Over short periods of time, stocks are more risky/volatile than bonds, and bonds are more risky/volatile than cash. Over longer periods, investors have been rewarded for taking additional risk (i.e., managed risk and volatility are not necessarily bad).
- **Costs:** Control the costs associated with investments. It is important to seek out value, not just the cheapest investment or strategy. While an index may be the least expensive strategy, it may not be the most appropriate investment for a particular asset class or the best way to meet a RoR.
- **Saving:** A great deal of stress can be reduced by putting the time value of money to work. Regular saving in retirement plans and dollar-cost averaging into markets often yields results. The more invested, the less pressure there is on investment performance and RoR.
- **Taxes:** If investments are successful, investors will pay tax. However, how much tax is paid can be controlled by being tax efficient in both investment selection and investment location (taxable, IRA accounts, Roth IRA accounts, etc.). Additionally, losses can be put to work with ongoing tax loss harvesting.
- **Participate:** A final element that can be controlled is participation in the market. Don't get bogged down in analysis paralysis. The most important decision is not what to invest in, or when to invest, but to be invested. Putting money to work is most often the right choice.

Does an Investor Know Their RoR?

One practice that typically does not yield results is, in a bull market, investors benchmark returns versus the S&P 500. Then, in a bear market, they will turn around and benchmark against cash. Both of those benchmarks are largely irrelevant to the individual investor. Instead, establishing a personal, required RoR is usually the better strategy. Rate of return is a carefully calculated number that takes into account the goals and desired time horizon unique to each individual investor. Rate of return is the benchmark that can and should be used to measure success.

In calculating RoR, investors should ask the following:

- **Goals:** How much money do I need to do what I want in my life? What is most important to me?
- **Quantify Dollar Amounts:** How much will I need to achieve those goals?
- **Time Horizon:** When do I want to realize these goals?

Each investor should consider these questions in terms of what would be ideal and what would be acceptable. This framework then acts as guardrails to help prioritize your goals. After completing the planning exercise, investors then back into their RoR and develop an asset allocation policy to achieve it.

The RoR should provide a high probability of achieving goals at the lowest level of risk necessary. Note, lowest risk necessary is different (and better) than the maximum tolerable risk. A disciplined asset allocation approach will guide investors to sell assets that are doing well (high) and buy underperforming or lower volatility asset classes (low). While sometimes difficult emotionally, this strategy can be highly successful. In regular intervals, investors should then reassess goals, review the quality of investments, and rebalance to lock in profits when appropriate.

Identify and Remove Cognitive Bias

Emotional biases are based on feelings, not fundamentals. Even the most rational decision maker may become irrational during times of market volatility. So it is critical to know oneself as an investor and understand what triggers irrational behavior. The following are just some of emotional biases that investors can experience:

- **Loss Aversion Bias:** I find the pain of losses far greater than the pleasure of gains.
- **Status Quo Bias:** I'd like to keep things the same because I've always invested this way.
- **Anchoring Bias:** I review investments based on cost vs potential return or risk. I need to make my money back before I can sell.
- **Mental Accounting Bias:** I treat pockets of money differently vs collectively; I have a bucket of cash earmarked for vacation while another debt is accruing interest I could pay down.
- **Recency Bias:** I give added weight to recent events and extrapolate trends.
- **Regret Aversion Bias:** I avoid taking action because I fear any decision will be unwise.

A good financial plan can become great if adhered to during times of market unrest. More often than not it is best for investors to turn off (or at least turn down) market noise from outside influences, as well as what is inside their head.

Removing emotion and bias is difficult to do, so it is wise for investors to find an advisor they trust to work with. An objective, unbiased advisor will help develop and implement a plan, and, in doing so, challenge assumptions and stop emotional decision making.

These three pieces of advice may seem simple in nature and much more often than not, wealth is built over time with patience, discipline and consistency. The ultimate measure of successful investing is not beating an irrelevant index or timing the market, but in finding an appropriate level of risk and asset allocation strategy that achieves the most important personal goals.

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