

StepByStep

TAX AND FINANCIAL PLANNING

Quarterly Newsletter

- Winter 2010 -

Not A New Depression

By Kenneth F. Robinson, CFP® (Cleveland, OH)

In February 1954, Time magazine and the St. Petersburg (FL) Times quoted labor leader Dave Beck: "I define a recession as when your neighbor loses his job, but a depression is when you lose your own." His comment, which became a popular saying, captures how challenging it can be to distinguish between a recession and a depression.

Are we actually in a depression now? As bad as things have been, and despite the comparisons you've probably heard, this recession is not another Great Depression.

There is no single definition of a "depression." When real gross domestic product (GDP), a measure of the size of an economy, drops by 10% or more, economists commonly describe the situation as a depression. But this recession has so far been marked by only a single-digit decline in real GDP (less than 4% through the end of March 2010). By contrast, real GDP declined by more than 26% during the depression of the 1930s.

What about unemployment? Rates have been high, especially in some areas of the country. According to the Federal Reserve, nationwide unemployment has so far topped out at slightly above 10%. That's hardly good news. But it's not nearly as high as the estimated 25% unemployment rate of the 1930s. Also, far fewer households 80 years ago had two earners. It's always upsetting when someone loses a job. But the loss of one job in a two-income household has less impact than the loss of the only job in the household. A substantial number of families experiencing unemployment today still have some income and thus are still putting money into the economy.

A similar point can be made about unemployment compensation, which didn't exist until the 1930s. We may think its main purpose is to help support a family experiencing a job loss. But the benefit to the larger economy is that the family has some money to spend, which stimulates economic activity and helps blunt the recession.

What about the recent spike in bank failures? After only 3 failures in 2007, the Federal Deposit Insurance Corporation (FDIC)



reported 25 bank failures in 2008 and 140 in 2009. So far in 2010 there have been more than 140. But this number doesn't come close to the roughly 7,000 banks that failed in the wake of the 1929 stock market crash (about 4,000 of those in a single year). It's also not as severe as the fallout from the savings and loan crisis of the 1980s when about 1,600 banks failed (534 of those in 1989 alone).

In addition, the nature of a bank failure has changed. When a bank failed in the 1930s, depositors lost their entire savings. Today, when the FDIC decides a bank has failed, regulators swoop in—like a SWAT team with briefcases and laptops—often around closing time on a Friday. In most cases, by Monday morning the bank is open for business as a branch of a stronger bank. The most noticeable difference is usually that the signs for Failed National Bank have been replaced by those of Stronger National Bank.

If the situation isn't nearly as devastating this time around, why does it seem so awful? First, the news cycle has changed. Instead of catching up on the latest events in a morning or an evening paper, news is now a 24/7 business, with intense competition for our attention. The media makes its money by selling advertising, so the news story has to be juicy enough to keep you watching when the ad comes on. It doesn't mean the news is necessarily giving you any information that's helpful in figuring out what action you should take next.

Also, for most of us, the current economic conditions are far more challenging than anything we've faced so far in our lives. The Great Depression may have been much worse, but this situation is happening to us, not to our grandparents or great-grand-

INSIDE THIS ISSUE

PG 2 - Not A New Depression

PG 3 - Spot & Stop Senior Financial Exploitation

PG 4 - A Taxing Election Season

PG 5 - Finding A Safe Withdrawal Rate

Continued on page 5 >>

How To Spot And Stop Senior Financial Exploitation

By Judy A. Stewart, CFP® and Marcie Grube (Carlsbad, CA)

Senior financial abuse is a chord that strikes close to home. My 88-year-old mother lives alone, and I worry that she could be vulnerable. The financial exploitation of seniors is very prevalent. According to the North American Securities Administrators Association (NASAA), Investor Protection Trust (IPT), and the National Adult Protective Services Association (NAPSA):

- Half of older Americans exhibit at least one sign of current financial victimization.
- Almost half of those aged 65 or over (44%) got at least two of four questions wrong about basic investment knowledge.
- About one of three older Americans (31%) say they are vulnerable in one or more ways to potential financial victimization.
- Only 2% of Americans 65 or older say their health-care provider has ever asked, “How you are handling money issues or problems?”
- Four of 10 children of parents age 65 or older are “very” or “somewhat” worried that their parents “have already become or will become less able to handle their personal finances over time.”

Sounds scary, doesn't it? Fortunately, some people are taking action. The NASAA, IPT, and the NAPSA, along with medical professionals and social workers, are banding together to create the Elder Investment Fraud and Financial Exploitation project, whose job is to stop a “rising tide of economic exploitation of the elderly” (Kristof, Los Angeles Times, June 20, 2010).



Sheryl Rowling, of Total Rebalance Expert, highlights the three most common ways a senior might be exploited:

- Telemarketing scams: More than a third of telemarketing fraud victims are over 60 years old. The most common scams are free vacation packages, time-shares, sweepstakes, phony charity fundraisers, and expensive 900 numbers.
- “Free lunch” investment seminars: Shady financial advisers often lure seniors to a free lunch or dinner, promising advice on “senior” issues such as living trusts or estate planning. Once there, seniors are pressured into purchasing dubious investments such as annuities or promissory notes. Although technically legal, these products are monumentally bad choices for retirees—illiquid, complicated, and booby-trapped with high fees.
- Religious or social group fraud: Among con artists' favorite targets are members of close-knit religious or social groups. The con joins the group and then tries to sell fraudulent investment schemes to members. (Sheryl Rowling, “Beware Senior Financial Abuse,” June 10, 2010)

What can you do to prevent senior financial abuse in your family? Rowling suggests family members simply sit down and discuss their financial concerns with their senior relatives. Of course, this can be a sensitive subject for seniors who want to remain independent. Calmly reviewing best practices can be a good reminder for seniors.

- Documenting financial arrangements can prevent misunderstandings. Review estate plans and wills every few years with senior family members.
- Encourage senior family members to stay active in their community. If they know where to turn for help, they'll be less likely to be exploited.
- Check references of those who help seniors in and around their homes. This can protect against con artists looking for an easy target.
- Don't give out personal information such as ATM or credit card numbers, PINs, or Social Security numbers.

Most importantly, be engaged in the lives of senior family members. Ask about their acquaintances and friends. Con artists look for victims who are lonely and isolated. Seniors who are active and who have family and friends looking out for them are less likely to be targeted for financial abuse.

If you suspect a parent or other aging family member or friend might be a victim of financial exploitation, a counselor or financial advisor can provide expertise in a sensitive and potentially serious situation.

A Taxing Election Season

By David Gardner, CFP®, EA (Boulder, CO)

Between a summer recess and campaign season, Congress had little time to tackle a complex topic fraught with controversy: the federal tax code. The bottom line: barring new legislation, most of us will see income tax increases.

President Obama did pledge not to raise taxes on individuals earning less than \$200,000 and couples earning less than \$250,000. But the president cannot legislate income tax changes by fiat. With Republicans gaining members in the House of Representatives, they may hold out for an across-the-board tax cut instead of relief that extends only to upper middle income taxpayers. Senate Republicans conceivably could delay all tax legislation until next year.

If no new legislation is passed, here's what we would face beginning in 2011:

Ordinary income tax rates increase. Most taxpayers would pay more as the Bush tax cuts expire. The lowest 10% bracket will disappear and become part of the 15% bracket. For instance, this change covers joint filers earning up to about \$70,000 in taxable income. Those in the 25%, 28%, and 31% brackets (up to about \$385,000 in taxable income) will see their marginal rate increase by 3%. The top tax rate will jump from 35% to 39.6%. The result: almost anyone who pays federal income tax now would owe more in 2011.

Investment tax rates change. Even the wealthy have used the advantageous 15% tax on qualified investment dividends and long-term capital gains over most of the last decade. Without new legislation, the tax on long-term capital gains will increase to 20% for many. Even more onerous, the tax on qualified dividends would skyrocket from 15% to ordinary income tax rates, as high as 39.6% for high earners.

Estate tax returns with a vengeance. This year the unthinkable happened: the estate tax disappeared—for one year. The heirs of billionaires like Yankees owner George Steinbrenner are saving hundreds of millions in estate tax this year. In 2011 the estate tax will increase to a maximum rate of 55% (from an effective 0% this year) with an exclusion of \$1 million—down substantially from even the 2009 exclusion amount of \$3.5 million.

Other changes. The alternative minimum tax (AMT), aimed at ensnaring high-income earners that take large deductions, could expand its reach to millions more next year, although Congress does have a record of approving higher AMT exemptions. Also, the 2010 hiatus of the itemized deduction phaseout for high earners would expire, reducing their deductible expenses.

As we get closer to the end of the year and have a clearer understanding of the tax landscape, we may see traditional tax planning turned on its ear. Usually the advice is to delay income and accelerate deductions, thereby keeping your dollars from the IRS for a few more years. But what should you do this year?

Accelerate income? As strange as it sounds, businesses and individuals should look at accelerating receivables to realize income this year. Investors with appreciated assets in taxable accounts should consider selling them to generate long-term capital gains in 2010, at a tax rate of 0 to 15% versus 20% next year. If you are in the 15% bracket or lower (about \$70,000 in taxable income for a married couple), this is a particularly viable strategy. If you can't maximize your retirement plan contributions for both 2010 and 2011, defer your savings until next year.

Roth conversions. In 2010 for the first time taxpayers can convert their traditional IRA into a Roth, regardless of their income level. This year only, the taxable income attributable to a 2010 conversion is deferred and split equally between your 2011 and 2012 returns, unless you elect to recognize it all in 2010. But do you want to defer your tax on the conversion? The problem is you could pay taxes on the 2010 Roth conversion at 2011 and 2012 rates. With tax rates likely to increase, it may make sense to decide to recognize the income for 2010. We may wait to see if we have a clearer indication of tax rates in 2011. However, don't wait too long because Roth conversions must be completed by the end of the year for these options to be available to you.

Tax-managed investing becomes more important. Now that advantageous dividend tax rates may expire, it becomes more critical to hold high-dividend investments in tax-deferred or tax-free accounts. You will derive more benefit from concentrating investments that generate highly taxed income (including most bonds, certificates of deposit [CDs], real estate investment trusts [REITs], and commodities) in qualified retirement plans or other tax-advantaged accounts. Tax-managed mutual funds that minimize dividends and distributed capital gains will become more significant for those holding equities in taxable accounts.

Although it may be unclear what tax rates we'll see next year, investors who are tax aware and who structure their portfolios accordingly will outperform those who ignore the impending changes.

Finding A Safe Withdrawal Rate

By Bert Whitehead, MBA, JD (Franklin, MI)

Q: Dear Bert: I have read that the safe withdrawal rate from an investment portfolio during retirement is around 4% if you want your money to last. Could you please comment?

A: Although I recognize the 4% withdrawal rate has become the standard wisdom in financial planning, I respectfully disagree. Keep in mind that most financial planners are actually investment managers. Minimizing the withdrawal rate keeps more assets under management for them and correspondingly higher fees.

It seems to me that a withdrawal rate must take into account the after-tax return to the client. This is highly individualized, depending on the client's tax situation and the actual tax efficiency of the portfolio. Using a tax-efficient Functional Asset Allocation portfolio, I am able to keep almost all my clients with investment portfolios under \$3 million in a 15% marginal tax bracket. This obviously impacts their appropriate withdrawal rate.

Most financial planners figure that a balanced portfolio in retirement with 60% interest-earning and 40% equities will earn about 7% over a 15- to 20-year period. This is historically true and the number I use. But then they assume a so-called inflation rate of 3% and the 4% withdrawal number.

I disagree that the inflation rate is the driver in retirement. The overall inflation rate has little relevance to the actual rate an individual client experiences.

The CPI (consumer price index) is heavily weighted by education, housing, and medical costs, none of which are significant to most retired people (especially health insurance). CPI may be meaningful in general, but most people who have a financial advisor are affluent to some degree. Ask yourself, "When gas went to \$4 a gallon, did that affect my standard of living?" Many financial planners use software that depicts an inflated future as

a single estimated percentage increase of past expenses. Clients are generally very capable of adjusting their behavior. If there is a lean year in the stock market, they put off expenses until times get better. Inflation software projections don't account for how smart clients are!

“Although I recognize the 4% withdrawal rate has become the standard wisdom in financial planning, I respectfully disagree..”

Retirement spending normally remains flat for the first 10 to 20 years of retirement as standard of living stabilizes. It is critical that planners monitor client spending during the first few years of retirement. If standard of living increases at the same rate as when people were working and increasing their earnings, they will certainly end up living beyond their means. In addition, the actual expenses needed to support clients' standard of living starts dropping around their late 70s and early 80s. They don't buy new cars or keep up with fashion demands. If we exclude gifts to charities and children, the amount they need decreases year by year, regardless of what the CPI does or how their portfolio performs. Recent studies published in the Journal of Financial Planning have corroborated this phenomenon.

(Continued from pg 2.)

parents. Naturally we experience it as a traumatically defining event.

As we've seen so many times before, this kind of instinctive emotional response is often the enemy of sound financial behavior. If you have concerns about how you should respond to current economic conditions, call your ACA advisor for a clearer understanding of what you should do and, just as importantly, what not to do.

Will we have a "double-dip recession"? No one will know for sure until it happens (or doesn't). But we have many reasons to be confident this recession won't lead to a repeat of the 1930s.

StepByStep
TAX AND FINANCIAL PLANNING

Financial Security. One Step at a Time.

2208 W. Detroit Street, Suite #208
Broken Arrow, OK 74012
918-806-6596

www.stepbystepfinancialplanning.com