

# Capital Financial Planners, LLC

Judith H. Heltzel, MBA, CFP® • Barrigan W. Nelson, CFP®  
503-585-1067 • advisors@capfina.com

Summer 2008

## School's Out! But Here's Your Homework

If you're like us, you've realized that summer is here and are now planning to take care of some previously neglected chores around the house or tend your garden when the weather decides to cooperate. We hope you will also put a review of your investment accounts on your to-do list.

Given the volatility we have experienced in the stock market this year, we think it's a good time to check in with us about whether your tolerance for the market's ups and downs has changed. We would be happy to sit down with you to review your allocation and risk statistics.

While you're in review mode, take note of recently increased contribution limits to IRAs and retirement plans:

- Maximum contribution amounts to IRAs increased to \$5,000 for 2008, or \$6,000 for those over the age of 50.
- Many retirement plan salary deferral limits have also increased in recent years. Those participating in a SIMPLE plan may now contribute as much as \$10,500, or \$13,000 for those over age 50. Participants in 401(k) plans may contribute as much as \$15,500, or \$20,500 for those over 50.

Another point to review: Make sure that your retirement plan, IRA, and life insurance beneficiary designations are as your estate planning attorney recommends.

Lastly, the most important suggestion we have for you this summer: Enjoy the sunshine!

Judy: 

## Economic Shifts Bring New Pitfalls And Prizes

Prepare yourself for a bumpy ride. As the new year dawned, most economists still expected the United States to avoid a recession in 2008. But then the stock market began a persistent downward slide, housing news kept getting worse, and America's economic woes seemed to spread around the globe. Add in the unpredictability of the presidential election and you have an equation that almost guarantees investors a turbulent year.

Consider these recent developments.

- The housing market remains in a tailspin. Faced with sluggish sales, sellers have been forced to slash their prices or take their homes off the market. With the current glut of homes, most experts don't expect much improvement before 2009.
- The subprime mortgage crisis hasn't abated, and major financial institutions continue to write down bad debt. Some estimate the total cost at over \$100 billion.
- The price of oil cracked the \$130-a-barrel threshold, and gas prices could soar to \$5 a gallon or more this summer.
- In 2007, the dollar suffered through its worst year since 2003, falling by about 9% against other major currencies. Low interest rates, a credit crunch, and related economic worries have kept foreign investors at bay.
- The Dow Jones Industrial Average set a record last year, but then suffered two of its biggest-ever daily point drops and slipped below 12,000 during the first quarter, and again in June.

It's impossible to know what the next months will bring. Steep interest rate cuts and an economic stimulus package may

eventually get the economy out of its doldrums, and investment markets could bottom out and begin a comeback. But an extremely tough year is equally possible.

What's an investor to do? These seven ideas could help keep you moving toward your financial goals.

**1. Diversify, diversify, diversify.** Now is not the time for big bets on asset classes or sectors. Instead, use a broad mix of investments to reduce downside risk.

**2. Review your asset allocation.** Even if you started out with a diversified portfolio, the recent market turmoil may have pushed it out of balance. For example, emerging markets have been outperforming other stocks, and what was once a relatively

small allocation to these investments may have grown to a much larger share of your overall holdings. You should sell some of those stocks or funds to reduce risk and get back to your original portfolio weightings.

**3. Investigate refinancing your mortgage.** Don't be scared off by the mortgage crisis if you qualify for a lower rate through a reputable lender. You could use some of your savings to pay off your new loan ahead of schedule.

**4. Shore up your cash reserve.** If you squirrel away enough cash, you'll be able to weather an economic storm or pounce when a good financial opportunity arises. You should set aside enough to last from three to six months, but more if you're self employed or feel your job is vulnerable.

**5. Prepare your bonds for uncertain times.** Questions about the economy, interest rates, and inflation could mean a volatile year for fixed-income investments. Creating

(Continued on page 4)



# Lifecycle Funds May Pose A Hidden Danger

**W**ouldn't it be nice to set your retirement plan on automatic pilot? Just adjust the timer button to the year you expect to retire — "2023 please" — and go about your business until that golden day arrives and the checks start pouring in.

That's the promise of lifecycle funds, also called target date funds. And while these funds are probably beneficial to younger workers who don't want to think too much about their investment portfolio, there are dangers lurking behind the promise of "no-effort" returns.

Lifecycle funds have exploded in popularity in recent years, and investors may now choose from among nearly 300, compared with about two dozen in 2000. These funds promise to take care of bothersome details for you such as asset allocation, diversification, and rebalancing. They invest in a combination of mutual funds, stocks, and bonds, and the mix is automatically adjusted over the years to reflect how close the investor is to retiring. The funds start out with an aggressive asset mix and slowly become more conservative over time.

This one-size-fits-all philosophy is fine for a group of 30-something workers investing through their company 401(k) plan, but once you approach age 50 these funds likely will

no longer be your best choice, especially if you have achieved a high net worth. That's because one size does not fit all when it comes to gifting assets to children, funding a college education, buying insurance, setting up trusts, and planning your estate.



If your goals include a second home in Maui, a late-life doctorate degree, and continued part-time consulting work, a lifecycle fund is not going to take those factors into account. Such individual needs are best addressed with individual advice.

Financial Planning Association offers some factors to consider:

• **How much money will you need to retire?** Sure, a lifecycle fund promises investment growth, but just how much growth do you need? What specific spending, income, or tax issues

will affect your investment picture?

• **How good is the lifecycle fund your employer offers?** Just because your company is offering a target fund doesn't mean it fits your needs.

• **What happens if you change jobs?** If you roll over these assets into another tax-advantaged retirement plan at another company, how will that match up to the strategy in the previous plan?

• **How much are you paying in fees?** If someone else is making the decisions, even if they are triggered automatically, how much are you paying for that service? Lifecycle funds are sometimes based on a fund-of-funds structure that layers a fee on top of the fees incurred by the individual funds.

• **How are you using the fund?** These funds are designed to provide all of the diversification an investor needs in one place. However, many investors are buying lifecycle funds while also placing assets into several other investment vehicles, resulting in overlapping investments. ●

You should consider a fund's investment objectives, risks, and charges and expenses carefully before you invest. The fund's prospectus contains this and other information about the fund, and should be read carefully before investing. A copy of the prospectus of the fund you are interested in can be obtained by contacting the fund company or our office.

## Be Very Careful, But You Can Make Penalty-Free Withdrawals

**I**RAs, obviously, are for retirement. And except in very special circumstances—say, if you've come into a major inheritance—the money in your retirement account ought to be off limits for any other purpose. But if your financial plan shows you really won't need your IRA for retirement, there's another way you could use it, even if you have not yet passed the age 59½ threshold to make penalty-free withdrawals. You could pull out cash to pay for your children's education.

The basic rule is pretty simple. Though you'd ordinarily incur a 10% early withdrawal penalty for taking

a distribution from your IRA before age 59½, that doesn't apply if the money goes to pay qualified education expenses for you, your spouse, or any child or grandchild of you or your spouse. And for these purposes, "child" is defined rather broadly. A stepchild, a legally adopted son or daughter, or even a foster child (subject to some conditions) can qualify.

Almost any post-secondary educational expenses count for this preferential treatment. The money for tuition, fees, and books can come out of your IRA as long as it goes to an accredited college, junior college, or graduate or professional school. The

school can be public or private, nonprofit or for profit. If the student is attending at least half time, room and board counts, too.

Though there's no preordained ceiling on the educational costs an IRA withdrawal can cover, you can't take out more than the total qualified expenses incurred during a particular tax year. You'll also have to subtract the amount of any other tax-advantaged distributions or aid applied to school costs. This may include tax-free Coverdell distributions, the non-taxable portion of scholarships or fellowships, Pell grants, or tax-free assistance from your employer, among other things. But

# Planning Ahead A Couple Of Generations

**U**.S. estate tax laws have been in flux for most of a decade, and the biggest changes are yet to come. Unless Congress dictates otherwise, the individual estate tax exemption is due to jump from \$2 million in 2008 to \$3.5 million in 2009. The following year, there's an unlimited exemption (in other words, no estate tax at all), and in 2011, the exemption drops to \$1 million. Yet as crazy as all of this may seem, a standard estate-planning tool—the “dynasty” trust—can help you avoid problems.

A dynasty trust, a type of generation-skipping trust, is an irrevocable trust that could benefit several generations of your family. Set up correctly, it can help you sidestep gift and estate taxes while also shielding trust assets from creditors. And the sooner you establish the trust, the longer its assets will have time to grow.

With a typical dynasty trust, you'll designate your children and grandchildren as discretionary beneficiaries. Then, when your children die, the trust remains in effect for their children, with payments continuing for generations. Because beneficiaries don't own the assets—instead, they receive income from the trust—there are no estate taxes when a beneficiary dies. That lets the principal keep growing, and assets may be shielded from divorcing spouses, court judgments, and other creditors.

When considering a dynasty trust,

there are several tax rules and exemption amounts to keep in mind. The exemptions from estate tax also apply to something known as the generation-skipping transfer (GST) tax, which applies to gifts to generations beyond your children. Moreover, everyone is entitled to a \$1 million lifetime exemption from gift tax liability, plus you can make yearly tax-free gifts of up to \$12,000 to as many beneficiaries as you like, as long as a “Crummey” provision is diligently applied and executed.

In establishing a dynasty trust, it makes sense to embark on a simple wealth transfer program, making annual \$12,000 gifts to all of your children and grandchildren. Your spouse can do the same. If you designate, say, eight yearly recipients, together you'll be able to move \$192,000 out of your estate each year. In 10 years, that's almost \$2 million.

Your next step could be to fund a dynasty trust with \$1 million (or \$2 million for a couple), using up your lifetime gift tax exemption. There's one catch, though. Gifts in excess of the \$12,000 per year reduce your estate tax exemption dollar for dollar. So if you start a trust with a \$1 million gift and then die in 2009, for example, your estate will be able to exclude only \$2.5 million from estate taxes, not the \$3.5 million otherwise allowed.

And if you'd like to begin the trust

with more than \$1 million, perhaps using up the higher GST exemption of \$2 million in 2008 (or \$3.5 million in 2009), a lifetime qualified terminable interest property (QTIP) trust could help. A QTIP trust allows the surviving spouse to use the trust property with taxes deferred until his or her death, after which the trust property goes to the final trust beneficiaries, who were named by the first spouse to die.

The federal government imposed the GST tax in 1986 to prevent people from using trusts to circumvent estate taxes of the next generation of heirs. Now, you can take advantage of the recent increases in the GST tax exemption by making lifetime gifts to a QTIP trust of up to the GST exemption amount.

Then, through your spouse's will, stipulate that upon the spouse's death, any estate taxes on this money will be paid with funds from his or her estate, outside the QTIP. That would allow the trust assets to pass to future generations without being reduced by estate taxes.

The longer a trust continues in existence, the greater its potential appreciation. To extend the life of a dynasty trust as long as possible, set it up in a state that allows such trusts to continue for hundreds of years or in perpetuity—which is the point of a dynasty trust. Most states have laws forcing trusts to terminate 21 years after the death of the last beneficiary living at the time the trust was created, though more and more states are extending that time limit. If you don't reside in a state that has repealed or extended the maximum term for trusts, consider establishing your trust in another state with more favorable laws. That's permitted as long as the trust has some connection to the state. One simple way to meet that requirement is to choose a trustee there, which could be a corporate trustee. But, be aware there is not yet any case law sustaining the effectiveness of a dynasty trust established in a state other than the state of the beneficiaries' residence as it relates to asset protection.

We can work with your attorney to help you decide whether a GST, dynasty, or QTIP trust makes sense as part of your long-term financial and estate plan. ●

## From An IRA For Education Expenses

the amount you can withdraw without penalty won't be reduced by payments from other sources, including your income, loans, gifts, or withdrawals from 529 college savings accounts.

The only real downside to using IRA money—again, assuming you won't need it for retirement—is that withdrawals for education from a traditional IRA will be taxed as income. If the withdrawal comes from a Roth IRA funded with after-tax dollars, only the portion deemed to come from account earnings will be taxed.

Moreover, any tax you pay on an IRA withdrawal poses another problem. Your penalty-free distribution is capped

by the amount of qualified educational expenses less any adjustments for tax-free awards. You can't withdraw enough to generate that total amount after taxes; you can take only the amount itself. So, for example, if the expenses amount to \$50,000 and you pay total federal and state taxes of 40%, that extra \$20,000 will have to come from outside the IRA. If you take the entire \$70,000 from your IRA, the 10% penalty applies to the \$20,000, increasing your tax bill by \$2,000.

Just be sure you don't need the money to fund your retirement and have that all figured out first in a detailed financial plan. ●

## Economic Shifts

*(Continued from page 1)*

a bond ladder<sup>1</sup>, a strategy in which you buy bonds with different maturities and reinvest at prevailing rates when short-term holdings mature, will help you minimize risks, but may not be ideal while interest rates remain low. In this environment, favor short-term bonds for more upside, less volatility, and less inflation risk than long-term bonds.

Be sure to examine bond holdings for hidden risks like mortgage-backed securities, bonds issued by shaky financial institutions, or paper that has been or is more likely to be downgraded. Even money market funds may now exhibit new risks.

**6. Consider joining the gold rush.** In late 2007, gold prices reached their highest level since the gold boom of 1980, and many experts expect a further rise. Investors

typically turn to gold as a hedge against a weak dollar and rising inflation, but until recently, buying bullion or gold coins meant also having to pay storage and transportation fees. Now, exchange-traded funds<sup>2</sup> enable you to own gold without the hassle.

Remember, the price of gold can be volatile and has already appreciated significantly. It is a good idea to wait for a price dip to buy, and limit your gold investment to a small percentage of your holdings. Diversified commodity funds are a less-risky alternative to buying gold directly.

**7. Maximize tax benefits.** This may be a year when some market losses are inevitable, but you can use them to help keep your tax bill in check. Capital gains



and losses cancel each other out for tax purposes, and, if you lose more than you gain, you can use the excess to offset up to \$3,000 of ordinary income in 2009.

We're ready to help you with strategies that could turn a bad year to your advantage. If you're nervous about the economic outlook and wonder whether you're on track to reach your financial goals, please give us a call. ●

1. All bonds, including Treasury bonds, fluctuate in value day-to-day. If sold prior to maturity, they may be worth more, less, or the same as your original investment.

2. You should consider an Exchange Traded Fund's investment objectives, risks, charges, and expenses carefully before you invest. The fund's prospectus contains this and other information about the fund and should be read carefully before investing. A prospectus may be obtained from your advisor or from the fund company directly.

Articles are written by a journalist contracted by Capital Financial Planners, LLC. This newsletter is for informational purposes only and is not to be construed as tax, legal or investment advice. Certified Financial Planner Board of Standards Inc. owns the certification marks CFP®, Certified Financial Planner™ and CFP® in the US.



1640 Liberty St. SE  
Salem, OR 97302  
503-585-1067  
advisors@capfina.com