

# BFAS Money Line

## INVESTMENTS

### Whither the Market Now!

One of the things which occurs to me as the occasional prospect questions my sanity for not being completely invested in the US large company market is whether they have a windshield in their car or do they just drive by looking in the rear view mirror?

While I certainly do not have a clear windshield (more like peering out that first hole in one covered with ice), I understand the **long-term advantages of a properly diversified portfolio.** When one portion of that diversified portfolio is performing poorly (in this case, foreign stocks), it is easy to question why more is not invested in the better performing portions of the portfolio.

The **purpose of a diversified portfolio is to minimize risk while maximizing performance.** Overloading in one sector adds risk and presumes foreknowledge of which sector will outperform in the short term. **Of course, if I (or anyone else) could predict that, we would be rich ourselves!**

The following chart shows asset classes ranked by performance during the 4<sup>th</sup> quarter



*"I've decided to put our readers first for a change. We'll tell them to diversify, buy and hold and save at least 10% of their income. Then we'll shut down the magazine because there's nothing else to say."*

of each of the last five years. How many of you knew that bonds were the highest performing asset class last quarter?

Ranking by Asset Class

	97	96	95	94	93
Growth	7	4	7	5	5
Growth & Income	4	2	2	6	6
Equity Income	2	3	1	8	7
Small Cap	8	9	8	4	4
Foreign	9	6	9	9	2
Emerging Mkts	10	10	10	10	1
Real Estate	5	1	4	1	10
Corp Gen'l Bds	1	7	5	3	8
Corp Hi Qual Bds	3	8	6	2	9
World Bonds	6	5	3	7	3

Note: Based upon 4<sup>th</sup> qtr rtns. Data from Morningstar.

The point is that a properly diversified portfolio does not guarantee the highest returns

every quarter. Though pundits may, with perfect hindsight, point out this or that asset class which excelled in the short term, the **overall portfolio will outperform over the long term.**

I recall that economists predicted 10 of the last 5 recessions (no, that is not a typo)! In January 1995, 48 of 50 economists predicted interest rates at year end of 10% (they were 8% at the time). In December, 1995 interest rates were 6%. **Keep this in mind when you listen to a talking head on TV or anyone else predict the future!!**

## COLLEGE PLANNING

### Which Option Best?

The new tax law has added to the bewildering array of options for parents trying to figure out how to pay for college. In addition to gifts to custodial accounts for the children, gifts directly to college to pay for costs, Minor's Trusts and Pre-paid tuition, we now have Hope scholarships, the Lifetime Learning Credit and the Education IRA.

Unfortunately, if your **Adjusted Gross Income (AGI) is over the \$160,000 limit for couples, you lose eligibility for the Hope scholarships, Lifetime Learning Credits or Education IRAs.** The Virginia Prepaid

**Tuition Plan** is a potential vehicle I have discussed before. While I am not generally a fan of it, you might want to talk to the grandparents about funding one.

You **must consider whether all of the children's education will be paid by the family or whether they will need scholarship or loan help.** If they will need help, putting assets in their name (custodial accounts, Education IRA, etc.) will mean 35% of their money will be expected to be spent each year when determining their eligibility for help. Conversely, only 5.3% of a family's assets are expected to be used each year.

**What if the children decide not to go to college?** If the money is already in their name, it becomes theirs at age 18. They may use it in ways you would not appreciate. Not going to college also negatively impacts the Pre-paid Tuition Plan and the Education IRA.

Of course there are tax advantages to putting money in the child's name. If you set up a custodial account, the first \$1,300 in income on this account would not be taxed (while the child is under 14). Once the child reaches 14, income would be taxed at the single tax rate.

You could establish a Minor's Trust. A Minor's Trust with you as trustees would allow you to spend the money for the child's college. If the child chose not to go to college, the money could be paid at age 25, 30, 35 or whenever you designate when you set up the trust. In this scenario, you give away the money permanently, but have more control of when the child gets it.

Many parents decide to **keep their assets in their name**

to maximize flexibility. I **recommend paying the school directly or gifting assets to the child for school.** Gifts directly to educational institutions do not count against the \$10,000 annual gift exclusion (\$20,000 for both) you have available.

Should you choose to give money directly to your child, there are other considerations. If, at that time, the **child is in a lower tax bracket (very likely), you might want to gift mutual funds or stocks directly to the child and let the child sell the mutual funds at a lower capital gains rate (10%).**

The **\$1,500 Hope Scholarship Credit** will probably be one of the most used options. Good for the first two years, it **covers tuition and certain fees,** not lodging, books, athletic or student activity fees. You must have at least \$2,000 in qualified expenses. **If you claim your child as a dependent but the child is paying for qualifying expenses, you (parent) can still claim the credit (if your joint AGI is under \$100,000).**

The **\$1,000 Lifetime Learning Credit (20% of up to \$5,000 of qualified expenses)** is available any year. While several students may be eligible for Hope Scholarships in a year, they may only use one or the other, Hope or Lifetime, not both.

I have seen little excitement for the **Education IRA** primarily due to the **\$500 per year** contribution limit. Also, you can not contribute to an Education IRA and Prepaid Tuition in the same year. This **might be another avenue for grandparent contributions. Congress is considering raising the contribution limit to \$2,000 per**

**year.** That could really make this a much more viable option.

## TAXES

# Refinancing?

If you are considering **refinancing your home,** don't miss out on a potentially significant tax deduction. If you paid points on a previously refinanced loan, you were required to amortize the points over the life of the loan. (New loan points are deductible in the first year of the mortgage). Thus, **if you still have points not yet deducted from a previously refinanced loan, you can deduct the points in the year you refinance.**

# FLPs

The **IRS has shown** in at least three instances in 1997 that **Family Limited Partnerships (FLPs) may not get the minority discounts advertised.** These were situations where people within months of death placed many of their assets into a trust and used the trust to fund an FLP in exchange for partnership interests. The persons' estates then claimed a minority interest or lack-of-control discount on the partnership interests resulting in a 40% to 98% drop in value for estate tax purposes.

**In each case, the IRS ruled that the transfer of trust assets to the partnership should be regarded as having taken place at death and the existence of the partnership should be disregarded.**

## RETIREMENT

## Need More Income?

So, you finally retired and are planning to live comfortably for the rest of your life on the interest and dividends from your investments. Now **interest rates are going down, some say to below 5%**. How do you maintain your lifestyle?

What about those **high-yield bond funds** or those **emerging market bond funds**? They may provide some seductive yields now, but they are very risky.

While we have not had a real recession in some time, **high-yield bonds are vulnerable to defaults** during the next one. Remember, **they are offering to pay you higher interest rates for a reason ... to take more risk. Be sure you understand the risk before reaching for that higher yield.**

My recommendation is to invest your portfolio in a diversified mix of bonds and stocks, both US and foreign. The stock/bond and US/foreign mix should be tailored to your individual risk and income needs.

The stock portion will generally increase much faster than inflation. Thus, **you can receive the dividends and interest and then sell some investments occasionally to supplement.** Sure this seems like "dipping into capital". But **if your capital is growing (rather than fixed as in bonds or annuities or CDs), you have a much better chance of having your money**

last throughout a thirty year retirement.



*"I'm here to look into your home office deduction."*

## To Roth or not To Roth?

**Most of you should be contributing to a Roth IRA in 1998 instead of a deductible IRA.** Don't let that possible tax deduction today cause you to give up years of tax free income. For those with joint incomes over \$160,000, not so fast. IRS says no can do.

The real question is **whether to convert your existing IRA to a Roth IRA.** Every fund company/Bank is touting software to evaluate the benefits of such a move. Most are very simplistic and use a lot of assumptions. **Key variables include: age, types of investments in the Roth IRA, net worth, income needs, risk tolerance, investment time horizon, and inheritance considerations.**

Conversions in 1998 have the advantage of spreading the tax burden over four years. You must have an adjusted gross income of under \$100,000 to qualify (not counting the conversion money).

However, if you want to convert in some later year, you can still limit the taxes by converting only a portion of the IRA to Roth, not all of it (remember the \$100,000 rule).

**Why convert at all?** You pay taxes now to convert or pay later (upon withdrawal) if you don't. **The difference is paying taxes on your current value vice paying future taxes on a (hopefully), much higher value.**

Having run a number of comparisons, here are some trends I have seen.

**If you are nearing 70 now and will be needing your IRA money for expenses, converting may not be for you.** Since you can't withdraw money from a Roth for five years, conversion could cause a problem.

**One of the big advantages of a Roth IRA is not having to start withdrawals at age 71. For those who want to continue compounding for a spouse or children, the Roth could be a big advantage.**

Another issue is **where to get the money to pay the taxes on conversion. Don't convert if you don't have the liquid assets available to pay the taxes.** Pulling money out of the IRA to pay the taxes generates penalties which defeat the purpose of the conversion

Most analysis I have done shows that you **make up the difference in taxes paid in about 5 - 8 years.** After that, the Roth ends up being the better vehicle.

Here is an **example.** Couple, age 50 with \$20,000 in IRAs. AGI is \$65,000. Tax bracket 28%.

Conversion in 1998 would generate **\$1607 in taxes annually**

(total \$6428). The after tax lifetime income from the Roth is projected to be \$177,344, for the regular IRA \$147,613. That is a 20% increase in after tax income.

Here is another example. Couple in their late sixties with \$125,000 IRA, \$50,000 AGI, 28% tax bracket.

They would have to pay \$9688 annually for four years (\$38,752 total) in taxes to convert. The net amount to them would be \$934,859 without converting and \$1,257,631 over 28 years if they converted. This is a 34% increase.

What would happen if Congress really did pass a flat-tax bill which would exempt non-wage income? In that case, conversion would not have been a good idea. I believe we will have a good sense by the end of 1998 whether or not Congress is really going to pass a flat-tax. I recommend holding off on conversion until late 1998.

## \$3,000,000 Oversight?

I recently ran into some of the significant impact I have been preaching about on IRA beneficiaries and distributions.

Here was the situation. **Mother, a widow, died leaving over \$250,000 in an IRA account.** Thankfully, she named her two children as beneficiaries. If she had not done so, all the IRA would have been payable by December 31<sup>st</sup> of the next year.

The problem came from the children's advisors. **Both an attorney and a financial advisor said the children would have to take distributions of mother's IRA over a five year period.**

Actually, they have a **choice of five years or over the life expectancy of the eldest child.** Since the eldest child is 40, we are talking about a life expectancy of 42.5 years.

Distributed over five years (taxes paid, growth at 10%), the IRA would provide in excess of **\$4,000,000 over the 42.5 years.**

However, **taking the minimum money out over the whole 42.5 years would provide over \$7,000,000!**

Getting bad advice or not knowing the rules can have significant consequences. **Are your beneficiaries and distributions set up correctly? How about those owned by your parents?**

### CHILDREN WITH DISABILITIES

## Housing

I am happy to report that **Biznet**, a group of businessmen in the area who are raising money to purchase **housing for the developmentally disabled**, are **buying a four bedroom house**. This house, in addition to two condos already owned, are just the beginning of Biznet's efforts to reduce the 150 person waiting list for housing.

Also, I understand that **Heart Havens, Inc., the Methodist organization** I discussed in the last newsletter, is **close to obtaining a home in the area**. Things are looking up!

## SSI

If your **child is living at home, Social Security will reduce your child's benefit by 1/3 unless the child is paying fair share rent to you.**

I know, charging your child rent may not sound like something a parent would want to do, but hear me out. Social Security looks at your mortgage, insurance costs, utilities, repairs, and grocery costs, then divides by the number of people in the home to determine fair share rent.

Say fair share rent is \$300 per month. If your child paid anything less than that, SSI would be reduced by 1/3. Since **maximum SSI is \$494 in 1998**, SSI would be reduced by \$164.67 leaving \$329.33.

One way to **reduce the fair share rent is to apply for Food Stamps**. If the child is receiving Food Stamps (up to \$90), groceries are not counted in the fair share rent. Say this reduced the fair share rent to \$200 per month. In this case, the child could pay \$200 per month to you and keep \$294 plus \$90 in food stamps.

Just remember that the **rent payments to you are taxable as rental income and should be reported on Schedule E**. Otherwise an audit might not be a pleasant experience for you (how could it be any worse, you say!)

If your fair share rent payment is too high, charging rent might not be the thing to do. Just something to think about!

Edited and Published by:

**Ronald S. Pearson, CFP**

**Beach Financial Advisory Service**

**6204 Ocean Front Ave.**

**Virginia Beach, VA 23451**

**(757) 428-6634**

**E-mail: rpearson@pilot.infi.net**