The
# FINANCIAL UPDATE
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FEE-ONLY FINANCIAL PLANNING

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## Giving Up Some Luxuries Buys Some Peace Of Mind

Michael and Susan Walker thought they had it made in the shade. After years of ups and downs, Michael's business had finally turned the corner and he was able to give himself annual compensation of $250,000. After staying at home raising their two kids, Susan had reentered the workforce and had worked her way up to making $100,000 a year. The couple had managed to pay off their home mortgage and to fund their children's college costs without taking any drastic measures. It looked like a worry-free retirement was in the cards.

But that was before the stock market went into free-fall at the end of 2008. The stocks and other retirement plan assets that the Walkers were counting on to help pay for luxuries when they retired—a seaside cottage, a new top-of-the-line Mercedes, and lavish weddings for their children—lost about a third of their value. The recession hit Michael's business, too, forcing him to cut back his salary to $200,000. Now, with Michael at age 60 and Susan 58, they are left with stocks worth $1 million, a combined $700,000 in their 401(k) plans, and $500,000 in Michael's IRA. Their home, which had been worth $900,000, now would sell for$750,000.

In this hypothetical example, analyzed with a professional software package, it turns out that the Walkers will do well to live comfortably during retirement, let alone be able to afford all of those nice extras they'd been anticipating. By giving up the second home and the fancy new car, they can increase their probability of success to 82%, based on the software package. But they'll likely have to watch what they spend, and another downturn could leave them in perilous circumstances.

In today's post-recession world, there are millions of people forced to come to grips with new financial realities. Yet there are still ways to improve the odds of success and reduce anxiety over what's ahead. If your situation is similar to the Walkers, here are several ways to improve your future outlook.

**Tighten the monthly budget.** Take a long, hard look at how you're spending your money. Do you really need to dine out at pricey restaurants each week or keep season tickets for the local sports teams? By making a few sacrifices now that won't dramatically alter your lifestyle, you may be able to preserve more cash for the future. Furthermore, whatever you save can be invested, generating even more income. This reduction in standard of living has the most dramatic impact on your retirement because you get used to spending less which continues for your 20-30 years in retirement.

**Ramp up retirement plan contributions.** In our example, both Walkers were deferring just 5% of their salaries to their retirement plans. But that's considerably less than the maximum they could give to their tax-

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## *Employers Find Ways To Mitigate Liability On 401(k)s*

It's time to take more responsibility for your 401(k) plan.

In the current economic environment, employees are blaming their employers for losses in 401(k) accounts. Many businesses have been accused of failing to meet their fiduciary responsibilities. High plan fees, poor communication and education, and lack of investment options all have come under fire, and there have been a rash of lawsuits against plan providers.

A recent survey by management consultant Hewitt Associates shows that employers have acted to improve their plans and protect themselves against such litigation. Almost seven in 10 respondents said they were very or somewhat likely to increase efforts to explain their 401(k) plans' fees, and 60% were very or somewhat likely to review their plan's governance structure. And more than half said they were very or somewhat likely to benchmark their plans against industry "best practices" this year.

One way to demonstrate you have acted properly in your employees' interest is to document the processes for meeting your responsibilities. Giving participants greater control over their investment decisions can also limit a fiduciary's liability. That means letting workers choose from a broad range of investment alternatives.

Finally, communication remains crucial. Make sure your employees know all of their rights and responsibilities under the plan.

John R Day Bill Ennis

# Not All ETFs Are Tax-Efficient Anymore

It used to be simple. One reason to consider investing in exchange-traded funds (ETFs) was that you would make out better at tax time than if you put your money into standard index mutual funds. But as ETFs have thrived, with exponential growth since their debut two decades ago, they've branched out from stocks to bonds and now to commodities and currencies. While those more esoteric ETFs provide a convenient way for ordinary investors to participate in hard-to-tap markets, they also bring tax complications that can hit you hard even if you hold on to your shares.

Standard equity ETFs resemble index mutual funds, in that both may be designed to track a stock benchmark. But when investors redeem mutual fund shares, the fund manager may need to sell holdings to come up with the cash, and that can generate taxable capital gains that the fund passes on to shareholders. ETFs, in contrast, are more like stocks; they're traded on exchanges, and most transactions involve existing shares. So, there's less selling of the assets in the fund and fewer immediately taxable gains, though you'll still owe taxes if you sell your shares at a profit.

Many newer ETFs, however, are tied to the value of commodities or currencies, and those may be taxed in many entirely different ways. Such funds are often organized as trusts or limited partnerships, complicated structures that may generate several kinds of taxes. And these ETFs can own a very wide range of assets, from actual currencies and commodities to all kinds of derivatives—futures, forward contracts, options—that may be subject to various levels and timing of taxes. In many cases, you end up paying more than the 15% rate that applies to long-term capital gains of stock ETFs and mutual funds.

Sometimes, you'll even be taxed on gains the fund hasn't realized. The IRS may require a commodities fund that holds futures contracts, for example, to "mark to market" its positions in those contracts at year's end— and you may be responsible for gains that don't yet exist. You could also be on the hook if you own shares in a gold ETF that holds bullion or gold coins. Shareholders of those funds are subject to a tax on "collectibles"—at a 28% rate for long-term gains. The earnings of currency funds, meanwhile, may be taxed as interest, at ordinary income rates of as much as 35%.

In most cases, potential tax liability shouldn't be a deal-breaker when considering an investment. Yet it is a consideration, and it's a factor we look at when working with clients to construct investment portfolios that fit their financial goals, investing timetable, and investment risk-tolerance. If you wonder whether ETFs belong in your investment mix—and what kind of taxation you might face—please make an appointment so we can discuss these issues. ●

**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 can be obtained from our office or from the fund company directly.**

# Health Law Relief For Small Biz Owners

The monumental new health care law—the Patient Protection and Affordable Care Act of 2010—will have a lasting impact. Yet while many provisions are to be phased in during the next several years, a few have already taken effect. For small businesses, one of the most important is a special tax credit that can help offset the cost of providing health insurance for employees.

Though this credit, too, will take several years to be fully implemented, some businesses may immediately qualify for the tax break. The IRS recently issued guidance on these complex rules, and it has posted examples, in the form of frequently asked questions (FAQs), on the web at http://www.irs.gov/newsroom /article/0,,id=220839,00.html.

The new credit is available to a qualified small business that purchases health insurance for its employees. For this credit, a small business is generally defined as a business employing no more than 25 full-time employees whose average annual wages don't exceed $50,000. For tax years from 2010 through 2013, the credit—which is subtracted from the tax bill the business would otherwise owe—equals 35% of the portion of employee health insurance premiums that a business pays. For tax-exempt organizations, there's a 25% credit that is subtracted from the income and Medicare taxes the group withholds for employees and the employer's Medicare contribution. The maximum credit increases to 50% (35% for tax-exempt organizations) in tax years 2014 and 2015, for a maximum of two years, if a company participates in a state insurance exchange and meets other requirements. Some 80% of small businesses may qualify for the tax credits, according to Families USA, a health care advocacy group.

Some businesses will do even better, qualifying for a credit that

# Twenty Top Tax Breaks In New Tax Act

The 2010 Tax Relief Act includes dozens of tax breaks for individuals and businesses. Here are 20 of the top provisions.

**1. No increase in income tax rates.** Rates in the top two income brackets had been scheduled to rise from 35% to 39% and from 33% to 36%. The new law also preserves relief from the "marriage penalty" for joint filers.

**2. Status quo for capital gains and dividends.** The maximum tax rate for long-term capital gains was supposed to jump to 20% (10% for low-income individuals), and dividends would have been taxed as ordinary income. Now, the existing 15% rate for long-term gains and dividends remains for most taxpayers through 2012.

**3. Lower payroll taxes.** For 2011 only, the law authorizes a two percentage point drop—to 4.2%—in employees' share of the Social Security tax, due on the first $106,800 of wages. You get the same break if you're self-employed.

**4. Alternative minimum tax (AMT) relief.** The new law slightly increases the exempt amounts on 2010 and 2011 returns for avoiding exposure to the AMT and its bigger tax bite. The amounts had been scheduled to revert to low, pre-2001 levels.

**5. No phaseouts for itemized deductions and personal exemptions.** Before 2010, itemized deductions and personal exemptions were phased out for high-income taxpayers. But those limits were repealed for 2010, and the new tax act extends that relief through 2012.

**6. A bigger break for owning qualified small business stock (QSBS).** The maximum 50% exclusion for investments in QSBS had been temporarily increased to 75%. Now, under the new tax act, there's a 100% exclusion for QSBS acquired before January 1, 2012.

**7. An enhanced education credit.** The American Opportunity Tax Credit (AOTC), which expanded the Hope credit for college expenses, was scheduled to expire after 2010. Now, the maximum $2,500 AOTC is extended through 2012, though it's still phased out for high-income taxpayers.

**8. A bigger deduction for college savings.** The maximum $2,000 deduction for contributions to Coverdell Education Savings Accounts, slated to drop to $500 after 2010, is extended through 2012.

**9. A partial reprieve for Section 179 deductions.** The maximum Section 179 deduction, which rose from $250,000 to $500,000 for qualified business property placed in service in 2010 and 2011, was then scheduled to drop to $25,000. The new law allows a maximum $125,000 deduction for 2012.

**10. A bonus for bonus depreciation.** The tax act retroactively reinstates this business perk, which had expired after 2009. A 100% bonus depreciation deduction is generally available for qualified property placed in service in 2011, and there's a 50% deduction for 2012.

**11. Revived credit for going green.** The credit for home energy-saving devices, scheduled to expire after 2010, is extended through 2011, but the credit is limited to 10% of the cost of improvements (it had been 30%) and a maximum of $500.

**12. Offspring benefit.** The child tax credit of $1,000 per child was going to lapse after 2010; now it will be in force through 2012.

**13. Help with adoption costs.** The new law extends the credit for adoption expenses—now a maximum of $12,170, down from $13,170 in 2010—through 2012.

**14. Money for hiring.** The Work Opportunity Tax Credit, available to businesses for employing workers from "target" groups, now won't expire as planned on August 31, 2011, but will stay in force through 2012.

**15. Reward for taking the bus.** The maximum monthly $230 tax-free benefit for transit passes, scheduled to decrease to $120 after 2010, is extended through 2011.

**16. A renewed deduction for corporate largesse.** Enhanced deductions for companies' contributions of food inventory, books and computer equipment, which expired after 2009, are retroactively extended through 2011.

**17. Option to deduct sales tax.** The chance to write off sales tax, rather than state and local income taxes, ended after 2009 but now is back for 2010 and 2011.

**18. Deduction for IRA transfers to charity.** The ability to direct an annual maximum of required IRA distributions to charitable organizations, which had expired after 2009, is retroactively extended through 2011.

**19. Generous estate tax rules.** Following the temporary repeal of the tax for 2010, it's reinstated but with a $5 million exemption and a top tax rate of only 35% and the reunification of estate and gift taxes through 2012. And heirs will again benefit from a step-up in basis on inherited assets.

**20. A break on generation-skipping tax (GST).** The new law coordinates the GST with the estate tax rules through 2012, with the same maximum exemption of $5 million. ●

offsets 100% of their health insurance premiums. That extra benefit applies to companies with 10 or fewer full-time employees whose average annual wages are less than $25,000. There's a phase-out formula for businesses with more than 10 workers or higher average salaries.

All of these rules are based on "full-time equivalents," so if your company employs more than 25 workers but has part-timers and seasonal workers, it still may qualify for a credit. And though compensation paid to owners and other highly paid employees would normally raise the average annual wages of a business—and might disqualify it from receiving the health insurance tax credit—the IRS has clarified that the calculation may exclude wages paid to a sole proprietor, a partner, a shareholder with a share of an S corporation of 2% or more, and any owner of more than 5% of another business. However, a single person business with no employees would not qualify for this tax credit.

Because all of this is complicated, be sure to work with your tax advisor to see whether your business can take advantage of the new rules. ●

# 5 Tips For Vacation Home Buyers

Buying or renting a vacation home has clear advantages over staying in a hotel. You get more space, more privacy, and more amenities. And now the economy is cooperating, too, with home prices at many popular vacation destinations falling during the nation's real estate slump.

If you're looking to buy or rent a vacation home, consider these suggestions.

**Define your goals.** Are you interested only in leisure, or are you looking for an investment property? If your goal is a place to get away from it all, start by looking in regions that offer the amenities you want. But if you're planning to rent out your property, think of what others might want.

***Ensure a safety net.*** Even if you are buying just for personal vacations, it's still important to consider the investment aspects, says vacation home expert Christine Karpinski, director of OwnerCommunity.com. "What if something changes with the market or with your personal situation?" Karpinski asks. "You want to have a safety net, and that's your ability to rent."

To evaluate an area's potential, find out who visits and why, Karpinski says. South Florida and Las Vegas, for instance, are primarily couples markets, so it's fine to buy a one-bedroom condo there, because it should be easy to rent out. On the other hand, North Carolina, New Jersey, and Cape Cod, Mass., are family markets, so you'd be better off buying a two- or three-bedroom condo that bigger groups would want.

**Check the amenities.** If you're renting, just make sure the property has the features that are important to you. But if you're buying, make sure it has what prospective guests in the region are likely to crave. You may not like hot tubs, but anyone trying to rent out a property in Colorado had better have one, Karpinski says.

**Consider proximity to attractions.** You may prefer to stay in a remote spot, isolated from other people. But rental potential may depend on whether the property is on a shuttle route to a nearby ski resort, for instance.

**Look at your overall financial picture.** How will you finance a vacation home purchase? And can you really afford it? "Real estate is a long-term investment, and it's always best to look at it in the context of your larger portfolio," Karpinski says. If you're considering a second home, we can help you explore all of the financial considerations before you make any commitment. ●

### Hot Spots:

Desirable areas where vacation home prices have fallen

- South Florida: Miami, Fort Myers
- Florida pan handle: Panama City Beach
- California: San Diego, Big Bear Lake, Lake Tahoe
- Las Vegas
- Phoenix
- Smoky Mountains: Gatlinburg, Tenn.
- Cape Cod, Mass.
- Colorado
- Manhattan
- Europe: London, Paris Rome, parts of Spain, the south of France
- Eastern Europe
- Central and South America

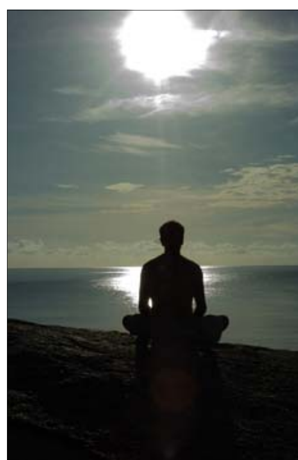
Source: Christine Karpinski, www.OwnerCommunity.com

## Peace Of Mind

*(Continued from page 1)*

deferred accounts. The current ceiling for annual 401(k) contributions is $16,500—or $22,000 for those, like the Walkers, who are over age 50. In addition, as a business owner, Michael could consider switching the company to another kind of retirement plan that permits much larger tax-deductible contributions.

**Postpone retirement.** In this example, Michael and Susan will both retire at age 66, the normal age at which they can collect full Social Security benefits. Yet if each one delays retirement by a single year, together they'll earn an additional $300,000 from their jobs, or more if Michael's business rebounds. That will also knock a year off the length of their retirement, and if they delay taking Social Security, they'll be able to draw larger monthly amounts. Putting off retirement longer would help that much more.



**Get off the sidelines.** The recent bear market hurt the Walkers, and after most of the damage had been done, they moved all of their 401(k) assets out of stock mutual funds and into cash. But that means they'll have trouble keeping up with inflation and gives them no chance to make up lost ground. Over extended periods, stocks have outperformed other assets, and with a few years left until retirement—and perhaps decades of life after they stop working—they need to consider moving part of their money back into equities.

How much or little you'll need to adjust your post-recession retirement savings depends in part on how long you have until you leave the work force. The closer you are to your retirement date, the more you may have to skimp now in order to be comfortable later. If you'd like us to review your plan and see what changes may be needed, please call our office for an appointment. ●

**John R. Day CPA/PFS  Bill Ennis CPA/PFS  125 Plantation Centre Dr., Bldg. 400 Macon, GA 31210**
**(478) 474-7480  www.dayandennis.com**

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