

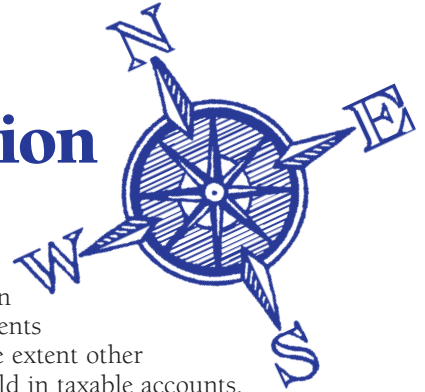


Retirement & Estate Planning



By Henry Becker

Location, Location, Location



The idea for this article came to me after a recent visit to my barber. As my barber, Rob, snipped away at my ever-decreasing number of hairs, he told me two very interesting stories. The first story was about when he decided to

open his own shop and his experience scouting for a location to hang his red, white, and blue barber's pole. The second story was about his recent house hunting experience with his fiancé. When I asked him what he was looking for in a home his response was, "the same thing I looked for when I found this place [the barber shop]... a nice place in a good location."

Anyone who has ever started his or her own business, looked for a house, or even set up a lemonade stand as a kid knows how important location is. Your investments are no different. For long-term planning, holding investments in the right "location" can make a significant difference in your portfolio's performance. The "location" of your investment is the type of account you hold your investment in: a taxable account or a tax-deferred account such as an IRA or 401(k). A recent academic study conducted by Carnegie Mellon and University of North Carolina professors has attempted to settle the ongoing debate over which asset class (equities or fixed-income investments) is better suited for tax-deferred accounts. The study concluded that, generally, income-producing investments belong in tax-deferred accounts and equities belong in taxable accounts.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 has enhanced the importance of investment "location" planning. Consider the following advantages of holding investments as indicated in the study:

Advantages of holding equities in a taxable account:

- **Lower Tax Rate** – Equities held in taxable accounts enjoy preferential tax treatment. Long-term capital gains and dividends are taxed at a maximum rate of 15%, compared with a maximum rate on ordinary income of 35%. In addition, gains can be deferred until the investments are sold. If you hold equities in your tax-deferred accounts, all income is deferred until you make withdrawals. However, you pay tax on your withdrawals at your ordinary income rate. This means that you lose the preferential tax treatment on your gains and dividends.

- **Realizing Losses** – You can use losses on your investments to offset gains, and to some extent other income, if the assets are held in taxable accounts. Generally, equities experience more price volatility than fixed income investments. Therefore, holding them in taxable accounts may create opportunities to claim realized losses resulting in lower taxes.
- **Stepped-up Basis** – If appreciated securities are held until death, heirs can benefit from a step-up in basis. (*Step-up in basis is a reset of cost basis equal to the value of the securities at the date of death.*) Assets held in a retirement account are not eligible for a step-up in basis. Since, over the long term, equities experience more price appreciation than fixed income investments, your heirs could benefit greatly from holding equities in your taxable accounts.

Advantages of holding income investments in tax-deferred accounts:

- **Deferral of Taxes** – This means the income produced from income-oriented investments — bonds, Real Estate Investment Trusts (REITs), Limited Partnerships (LPs), or bond funds — will compound tax-deferred until you withdraw the money. This strategy could provide significant current tax savings where an investor does not need the current income generated from his or her fixed income investments.
- **Lower Tax Rate** – By holding fixed income securities in a tax-deferred account you may pay tax on the income at a lower tax rate. When you hold income investments in a taxable account, you pay tax on the income at your current income tax rate. If instead you hold income investments in a tax-deferred account, you pay tax on that income when you make withdrawals. If withdrawals occur in retirement, when your tax rate may be lower, you effectively pay less tax on the same income.

Despite the advantages of this location strategy, other factors, such as income needs from your investments, diversification issues, and the size of each account type, may dictate a different approach.

We can help you determine the optimal location of your investments based on your individual circumstances. Call us to set up a free initial consultation with one of our advisors.

Investment Management



By Bob Ray

Individually Managed Portfolios— Not Just for the Super Wealthy

managed portfolio of stocks and bonds for a client. The rest of us were left to manage on our own using a stockbroker or buying mutual funds. In fact, mutual funds were created to serve the bulk of investors not served by the money managers. Although mutual funds served this market fairly well, they could not provide the many advantages that individually managed portfolios offer:

- Lower fees
- Lower taxes
- Less idle cash
- Portfolios tailored to meet individual income, growth, and risk requirements
- Professional asset allocation, ongoing oversight, and timely rebalancing

Fortunately, today many more people are able to take advantage of the benefits of individually managed portfolios. Technological advances have brought tremendous efficiencies to the business of money management, lowering costs and allowing managers to work profitably with portfolios much smaller than \$1,000,000.

One of the most important technological changes has been the replacement of the physical delivery of securities with electronic delivery or “book entry” systems. Under the old system, Wall Street firms had a lock on the investment business because physical delivery of securities required a presence on Wall Street. The new book entry systems facilitated the emergence of independent custodians such as TD Waterhouse and Charles Schwab not tied to the large brokerage houses on Wall Street.

Independent custodians effectively unbundled research, trading, and custodial services and helped reduce total costs to all market participants. As a result, money managers no longer need to trade through the large Wall Street firms in return for research, delivery and custodial services. And they no longer need to pay their prices. Trading commissions that used to cost an investor \$500 to \$700 per trade have been whittled down to \$25 or less.

Technological advances have also brought greater efficiencies and lower costs to the front office management of investment portfolios. With powerful PCs, new software, and the Internet,

money managers have unparalleled access to news, data, real-time pricing, and instant credit research. This allows managers to monitor large numbers of securities without needing trading rooms staffed by hundreds of professional traders. In addition, electronic downloads of client portfolios into sophisticated management systems allows for real-time decision making at a fraction of the cost of 20 years ago.



At BWFA, we can construct individual portfolios for clients starting at \$200,000. This minimum is set by both cost and diversification considerations. Modern portfolio theory suggests that a minimum of 40 stocks is needed to provide proper diversification. Buying more than 40 stocks tends to drive costs up without a corresponding decrease in risk. In addition, we believe the cost of a trade should not exceed .5%-1% of the value of the trade. Assuming transaction costs of \$25 a trade, and \$5,000 minimum purchase amounts for each stock to keep the cost at .5%, we can purchase 40 securities with a portfolio of \$200,000.

This means that many more investors than ever before can acquire individually managed portfolios of stocks and bonds. And they can do so at far less than the cost of using mutual funds. Ongoing management fees of mutual funds average 1.42%. Despite advances in technology, mutual funds have not lowered these costs over the years. In fact, the average management fee for equity funds recently reached an all-time high of 1.6%. Experts, including Morningstar and the famed John Vogel of the Vanguard Group, have estimated the true cost of mutual funds at closer to 3% when you include other factors such as trading costs, the effect of uninvested money to honor redemptions, and higher tax consequences. At BWFA, we charge .75%-1.25% to construct and manage a portfolio of individual securities customized to your needs. These fees properly reflect the reduction in costs brought about by technology.

Tremendous advancements in technology have been good news for investors. Today we can offer many investors all the advantages of individually managed portfolios, including lower costs, lower taxes, and portfolios tailored to your individual needs. If you have \$200,000 or more to invest, you should take a look at what an individually managed portfolio could offer you. By historical standards, these are truly bargain times in which to hire a professional money manager.

Tax Services



By Bob Cassel, EA 

Turn Your Hobby into a Business and Save Taxes

Why would you want to turn something you enjoy and do for fun into something that is intended to generate income? To save money on taxes, of course. In this article, we are going to explore the pros and cons of turning your hobby into a business. We will assume that you have a hobby that could legitimately earn some money. Good examples are photography, quilt making and other crafts, genealogy, and writing. Other possibilities would be activities that people might pay you to teach them or guide them in (kayaking, playing an instrument, etc.).

Making this transition offers some definite advantages. First of all, you may earn some extra income. Secondly, you may actually reduce your income tax liability. It is true that you will have to declare any income you receive from pursuing your hobby as a business. However, you will also be allowed to deduct dollar for dollar any expenses you incur producing that income, often generating a loss for the business and lowering your overall tax bill. Deductible expenses include:

- **Full deduction for direct expenses in producing the income** – Materials, supplies, advertising, office expenses, training, education, bookkeeping supplies, and the cost of any labor by employees or independent contractors.
- **A percentage deduction for expenses used partially for the business** – Home computers, software, connectivity, office furniture, an area in your home set aside as an office, cellular and land-line phone.
- **Automobile expense deduction for travel between places of business** – If you have another job besides your business, you can deduct auto expenses for travel between your home office and regular job.
- **Partial or full deduction for travel that focuses partially or entirely on your hobby** – The business portion of these expenses for you and your employee (say, your spouse) would be deductible. Trips to a conference, trade show, or to do research are a few possibilities. The deductible expenses would include hotel, meals, local transportation, and any other expenses while you are away overnight on business.
- **Medical insurance deduction** – If you buy medical insurance for yourself and your employees (including your spouse and

children if you employ them), you could receive a large deduction for this expense. (To qualify for this deduction, you cannot receive health insurance through another employer.)

- **Retirement contribution deduction** – You could make deductible contributions to IRAs for your employees (including your spouse and children if you employ them).

The downside of converting a hobby to a business is that you must commit to “trying” to earn a profit. In addition, once you have made the conversion, you cannot easily reverse it. The IRS guidelines say that in order to be considered a business, you must show a profit in 2 out of every 5 consecutive years. But, there are exceptions to this rule. For example, you can still qualify as a business if you can show adequate intent to make your business profitable. Ways to prove this profit motive include advertising, sending out bids or proposals, and joining professional associations or trade groups.

However, if you transition your hobby to a business, show a loss for 1 or 2 years, and then decide to go back to hobby status, the 1 or 2 years of deductions will probably not hold up under IRS scrutiny. You must be prepared to continue the business for several years.

If the idea of converting your hobby to a business appeals to you, first be sure you meet the following requirements:

- A desire and the opportunity to turn your hobby into something that generates both income and business deductions
- Acknowledgement that you will need to show a profit, or demonstrate intent to make a profit
- A willingness to carry on this business activity for several years or more

Once you have decided to convert your hobby to a business, new questions are likely to arise: “Which deductions can I qualify for?” “What record keeping is required?” “Should I employ my spouse or children?” “What type of business entity should I choose?” Do not worry. Just give us a call and we will help you through the decision making process.

