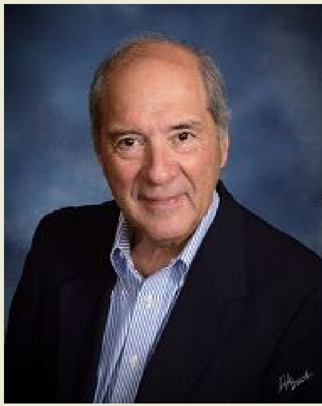

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Hope to hear from you all in the New Year. Health, Happiness and of course Wealth in 2016.

-Frank

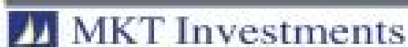
January 2016

Assessing Portfolio Performance: Choose Your Benchmarks Wisely

Estate Planning Strategies in a Low-Interest-Rate Environment

Rollover as Business Start-Up (ROBS)

I'm thinking about storing financial documents in the cloud. What should I know?



Assessing Portfolio Performance: Choose Your Benchmarks Wisely

You can't help but hear about the frequent ups and downs of the Dow Jones Industrial Average or the S&P 500 index. The performance of both major indexes is widely reported and analyzed in detail by financial news outlets around the nation.

Like the Dow, the S&P 500 tracks the stocks of large domestic companies. With 500 stocks compared to the Dow's 30, the S&P 500 comprises a much broader segment of the stock market and is considered to be representative of U.S. stocks in general. Both indexes are generally useful tools for tracking stock market trends, but some investors mistakenly think of them as benchmarks for how well their own portfolios should be doing.

However, it doesn't make much sense to compare a broadly diversified, multi-asset portfolio to just one of its own components. Expecting portfolio returns to meet or beat "the market" is usually unrealistic, unless you are willing to expose 100% of your life savings to the risk and volatility associated with stock investments.

Asset allocation: It's personal

Just about every financial market in the world is tracked by one or more indexes that investors can use to look at current and historical performance. In fact, there are hundreds of indexes based on a wide variety of asset classes (stocks/bonds), market segments (large/small cap), and styles (growth/value).

Investor portfolios are typically divided among asset classes that tend to perform differently under different market conditions. An appropriate mix of stocks, bonds, and other investments depends on the investor's age, risk tolerance, and financial goals.

Consequently, there may or may not be a single benchmark that matches your actual holdings and the composition of your individual portfolio. It could take a combination of several benchmarks to provide a meaningful performance picture.

Keep the proper perspective

Seasoned investors understand that short-term results may have little to do with the effectiveness of a long-term investment strategy. Even so, the desire to become a more disciplined investor is often tested by the arrival of quarterly or annual financial statements.

The main problem with making decisions based on last year's performance figures is that asset classes, market segments, or industries that do well during one period don't always continue to perform as well. When an investment experiences dramatic upside performance, it may mean that much of the opportunity for market gains has already passed. Conversely, moving out of an investment when it has a down year could mean you are no longer in a position to benefit when that segment starts to recover.

On the other hand, portfolios that are left unattended may drift and begin to take on too much risk or become too conservative. Rebalancing periodically could help bring your asset mix back in line with your preferred allocation.

There's really nothing you can do about global economic conditions or the level of returns delivered by the financial markets, but you can control the composition of your portfolio. Evaluating investment results through the correct lens may help you make appropriate adjustments and effectively plan for the future.

Note: *Keep in mind that the performance of an unmanaged index is not indicative of the performance of any specific security, and individuals cannot invest directly in an index. Asset allocation and diversification are methods used to help manage investment risk; they do not guarantee a profit or protect against investment loss. All investments are subject to market fluctuation, risk, and loss of principal. Shares, when sold, may be worth more or less than their original cost. Investments that seek a higher return tend to involve greater risk. Rebalancing may result in commission costs, as well as taxes if you sell investments for a profit.*

Estate Planning Strategies in a Low-Interest-Rate Environment

Low interest rates favor certain estate planning strategies over others, and the interest rates used by the IRS are at or near historic lows.

There may be costs and expenses associated with any of these strategies. Also, payments from these strategies are not guaranteed.

The federal government requires the use of certain published interest rates to value various items used in estate planning, such as an income, annuity, or remainder interest in a trust. The government also specifies interest rates that a taxpayer may be deemed to use in connection with certain installment sales or intra-family loans. These rates are currently at or near historic lows, presenting several estate planning opportunities.

Low interest rates favor certain estate planning strategies over others. For example, low interest rates are generally beneficial for a grantor retained annuity trust (GRAT), a charitable lead annuity trust (CLAT), an installment sale, and a low-interest loan. On the other hand, low interest rates generally have a detrimental effect on a qualified personal residence trust (QPRT) and a charitable gift annuity. But interest rates have little or no effect on a charitable remainder unitrust (CRUT).

Grantor retained annuity trust (GRAT)

In a GRAT, you transfer property to a trust, but retain a right to annuity payments for a term of years. After the trust term ends, the remaining trust property passes to your designated beneficiaries, such as family members. The value of the gift of the remainder interest is discounted for gift tax purposes to reflect that it will be received in the future. Also, if you survive the trust term, the trust property is not included in your gross estate for estate tax purposes. If the rate of appreciation is greater than the IRS interest rate, a higher value of trust assets escapes gift and estate taxation. Consequently, the lower the IRS interest rate, the more effective this technique can be.

Charitable lead annuity trust (CLAT)

In a CLAT, you transfer property to a trust, giving a charity the right to annuity payments for a term of years. After the trust term ends, the remaining trust property passes to your designated beneficiaries, such as family members. This trust is similar to a GRAT, except that you get a gift tax charitable deduction. Also, if the CLAT is structured so that you are taxed on trust income, you receive an up-front income tax charitable deduction for the gift of the annuity interest. Like with a GRAT, the lower the IRS interest rate, the more effective this technique can be.

Installment sale

If you enter into an installment sale with family members, you can generally defer the taxation of any gain on the property sold until the installment payments are received. However, if the family member resells the property within two years of your installment sale, any deferred gain will generally be accelerated. The two-year limit does not apply to stocks that are sold on an established securities market.

You are generally required to charge an adequate interest rate (based on IRS published rates) in return for the opportunity to pay in installments, or interest will be deemed to be charged for income tax and gift tax purposes. However, with the current low interest rates, your family members can pay for the property in installments while paying only a minimal interest cost for the benefit of doing so.

Low-interest loan

A low-interest loan to family members might also be a useful strategy. You are generally required to charge an adequate interest rate on the loan for the use of the money, or interest will be deemed to be charged for income tax and gift tax purposes. However, with the current low interest rates, you can provide loans at a very low rate, and family members can effectively keep any earnings in excess of the interest they are required to pay you.

Effect of low rates on other strategies

- **Charitable remainder unitrust:** You transfer property to a trust, retaining a stream of payments for life or a number of years, after which the remainder passes to charity. You receive a current charitable deduction for the gift of the remainder interest. Interest rates have no effect if payments are made annually at the beginning of each year, and low interest rates have only a minimal detrimental effect if payments are made in any other way.
- **Qualified personal residence trust:** You transfer your personal residence to a trust, retaining the right to live in the home for a period of years, after which the residence passes to your designated beneficiaries, such as family members. The value of the gift of the remainder interest is discounted for gift tax purposes to reflect that it will be received in the future. The lower the IRS interest rate, the less effective this technique can be.
- **Charitable gift annuity:** You transfer property to a charity in return for the charity's promise to make annuity payments for your life (or for the lifetimes of you and your spouse). You receive a current charitable deduction for the gift of the remainder interest. The lower the interest rate, the lower the amount of your charitable deduction. Also, charities have generally been forced to reduce payout rates offered because of economic uncertainties and the low-interest-rate environment.

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Rollover as Business Start-Up (ROBS)

When considering this technique, keep in mind that tax laws are subject to change.

What is it?

A rollover as business start-up, or ROBS, is an aggressively marketed technique for using qualified retirement assets to purchase a business. The following is intended only as an introductory overview of this interesting but extremely complicated topic.

How does it work?

In the typical iteration, you, as prospective business owner, set up a new C corporation. The new corporation then hires you as an employee and adopts a 401(k) plan. You become a participant in the plan and initiate a tax-free direct rollover of assets from an IRA (or a qualified employer plan from which you're entitled to receive a distribution) to your new 401(k) plan account.

The new 401(k) plan is structured to allow participants to invest in employer stock. You direct the plan administrator to invest your rollover contributions in stock of the new C corporation. Now the corporation has assets with which it can purchase a business, and your 401(k) assets consist of stock in the new corporation.

Are ROBS legal?

There is no specific provision of the Internal Revenue Code that permits or prohibits ROBS. The IRS has expressed concern that ROBS allow taxpayers to use retirement funds for their own benefit without having to pay any income taxes and penalties. The IRS has not, however, stated that ROBS are illegal per se, and ROBS are not on any list of tax shelters or tax avoidance schemes.

In 2008, the IRS issued a detailed guide on ROBS for its examiners (www.irs.gov/pub/irs-tege/robs_guidelines.pdf).

What kind of business can the plan purchase?

There are generally no restrictions. It can be a new business or an existing business. ROBS are often used to purchase a franchise. Keep in mind, however, that if the business has other employees, another layer of complexity is added.

Can I get a salary from the business?

In general, you can receive a salary if the funds come from the business's operating revenues, not from the cash the corporation received from the 401(k) plan's purchase of stock.

What happens when I want to retire?

Typically, the business would be appraised and a value assigned to the stock held by the plan. If the business will be ongoing, the plan would sell the stock to an unrelated third party and distribute the proceeds to you; they are taxed the same as any other distribution from a 401(k) plan. Otherwise, the business would be liquidated, the plan terminated, and again you would receive a distribution of any proceeds from the plan.

Why would I want to use a ROBS to start a business?

In many cases, it's difficult for individuals to find affordable financing to purchase a small business. Retirement assets provide a ready source of funds, and because you're not borrowing money, there's no interest or any loan repayments.

What's the downside?

There are many potential pitfalls:

- New businesses are risky, and many fail. You're risking your retirement nest egg, assets that you may not have time to rebuild. You need to consider what your retirement would be like if you lost all or part of these assets.
- ROBS are complicated structures involving corporations, trusts, and qualified retirement plans, and compliance with state and federal laws. Qualified plans like 401(k)s are complicated in and of themselves and are generally subject to rules issued by the IRS and the Department of Labor. Failure to comply with these rules can lead to disqualification of the 401(k) plan, which in turn could result in its assets being treated as an immediate taxable distribution to you and any other plan participants.
- If you are named as the plan's trustee and/or administrator, you would generally have fiduciary obligations to the plan and to any other employees covered under the plan. You could incur penalties--and personal liability to other participants--if you fail to satisfy those fiduciary duties.
- While the IRS has not declared ROBS to be illegal, they are clearly on the Service's radar, and you can expect close scrutiny for your plan and business.

Promoters of these plans are not all equal and there are associated costs. Some claim to have helped hundreds of business owners establish ROBS successfully, without a single plan being disqualified. Use due diligence when choosing a firm to help you with your ROBS.

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I'm thinking about storing financial documents in the cloud. What should I know?

Cloud storage--using Internet-based service providers to store digital assets such as books, music, videos, photos, and even important documents including financial statements and contracts--has become increasingly popular in recent years. But is it right for you?

Opinions vary on whether to store your most sensitive information in the cloud. While some experts say you should physically store items you're not willing to lose or expose publicly, others contend that high-security cloud options are available.

If you're thinking about cloud storage for your financial documents, consider the following:

- Evaluate the provider's reputation. Is the service well known, well tested, and well reviewed by information security experts?
- Consider the provider's own security and redundancy procedures. Look for such features as two-factor authentication and complex password requirements. Does it have copies of your data on servers at multiple geographic locations, so that a disaster in one area won't result in an irretrievable loss of data?
- Review the provider's service agreement and terms and conditions. Make sure you understand how your data will be protected and what recourse you have in the event of a breach or loss. Also understand what happens when you delete a file--will it be completely removed from all servers? In the event a government subpoena is issued, must the service provider hand over the data?
- Consider encryption processes, which prevent access to your data without your personal password (including access by people who work for the service provider). Will you be using a browser or app that provides for data encryption during transfer? And once your data is stored on the cloud servers, will it continue to be encrypted?
- Make sure you have a complex system for creating passwords and never share your passwords with anyone.

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