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Really BIG Questions

(Some people go into a hyperactive mode around the holidays. They get super busy with gift buying, decorating, entertaining, family gatherings, and traditions. If you are one of those, please save this article until you have some quiet time to think. If the end of the year is a more reflective time for you, this article may give you a head start thinking about your new year resolutions or your big goals.)

All too often, financial planning is equated with the easy stuff (for us at least) of number crunching, spreadsheets, money, and portfolio strategies. Instead, it is really about the much harder task of envisioning your future—the rest of your life—then coming up with the price tag, timetable, and the way to pay for your dreams. We try to help our clients with this process, particularly in the area of retirement planning with our list of 10 questions. (See the March 2006 issue of *Kelemen-Way Financial Perspectives.*)

But the following three questions are even better and more fundamental and also much harder to answer. Here they are, courtesy of George Kinder from his 1999 book, *Seven Stages of Money Maturity.* Pay attention to the really big blank spaces in this article—they go begging for your thoughtful answers.

Big Question #1

Assume that you've got all the money you need—enough for the rest of your life. Maybe you're not as rich as Warren Buffet or Bill Gates, but you never have to worry about money for any reason. ***What would you do with it? How would you live?***

Big Question #2

You go to your doctor. He or she discovers you have a rare illness. You're going to feel perfectly fine for the rest of your life, but the illness will prove suddenly fatal within five and ten years. ***Now that you know your life will be over in five or ten years, how would you live it? What would you do?***

Big Question #3

This starts out the same as question #2, but with a subtle and very important twist. You learn that you have a serious illness and have only 24 hours to live. The questions are, ***"What did you miss? Who did you not get to be or do? What are your regrets?"***

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It is so easy to get bogged down in the day-to-day realities of earning an income and raising a family. But if you take the time to think about these big questions, your answers will likely show you that not all of your dreams are tangible things that take money. **And what if the life you want—really want—requires less, not more money?** What would you do differently? What would you start or stop doing now?

Financial and life planning may not be so much about **where** you want to be or **what** you want to own, but rather **who** you want to be. As Lee Eisenberg in his wonderful new book entitled *The Number* says, "…an unexamined life may or may not be worth living—but it's almost always more costly than an examined one."

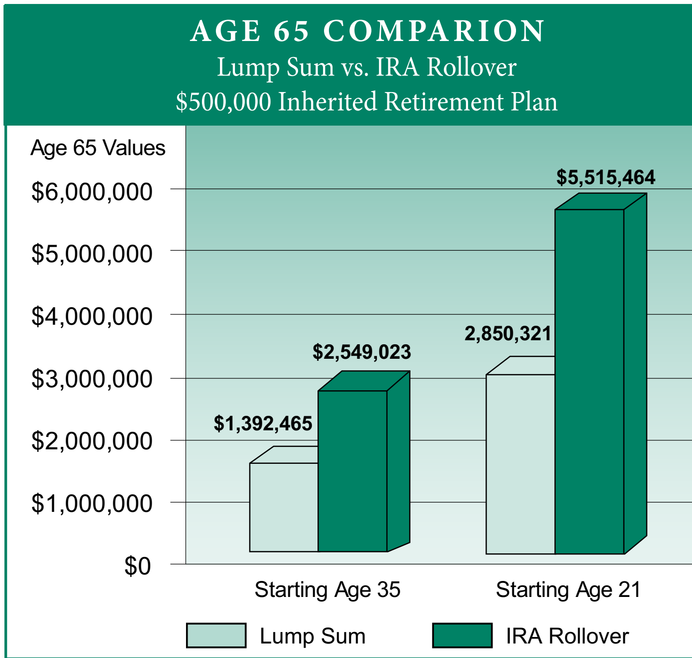
New Law Makes It Easier To Inherit A Retirement Plan

Sometimes good things come in big packages. The Pension Protection Act (PPA) of 2006 was signed into law August 17. It is 907 pages long, with another 386 pages of technical explanations. The guidebook and its attached committee reports are over 2,000 pages long. Interestingly enough, a good part of the bill deals with charitable giving, education funding, life insurance, and other issues unrelated to pensions. And many of these changes are positive.

One very nice gem buried in the bill was a provision to make it easier for non-spouses to inherit a qualified retirement plan, such as a 401-k, 403-b, or a 457 deferred compensation plan. There had been talk of making these changes for many years, but it took the September 11 terrorist attacks for Congress to see how the old rules were a very unfair burden on single individuals and families.

Previously, only a spouse could continue the tax deferral of an inherited retirement plan. Children, relatives, and domestic partners were often forced by the plan documents to withdraw the money from the retirement plan within five years (but more often immediately) and pay income taxes on the full amount. They experienced up to a 45% loss in value due to federal and state income taxes. A $500,000 distribution, for example, could see an immediate drop in value to $300,000 after taxes at a 40% combined Federal and state rate.

Starting in 2007 non-spousal beneficiaries can have the retirement plan balance rolled over to an "inherited IRA" account. They will still need to take annual minimum distributions, however, they can use their own life expectancies, which in most cases will be longer. The remaining balance continues to grow tax-deferred. This is huge, as you can see by the graph.



Assumes 40% tax rate on lump sum and required minimum distributions; 25% tax rate on investment growth outside IRA; 7% hypothetical investment growth, and that the lump sum and RMD payments are invested until age 65.

In that example, the remaining life expectancy of a 35-year-old was another 48.5 years, requiring a minimum distribution of $11,031. But if the beneficiary were, say, 21, the life expectancy is another 62.1 years and the minimum distribution would have been only $8,051, leaving a much larger balance to grow tax deferred in subsequent years. **These are the same results if an IRA were stretched out. So if you have already rolled your retirement plan to an IRA, your beneficiaries can accomplish the same thing—if they have the discipline to stretch it out.**

Unlike a spousal rollover, however, the IRA cannot be rolled over into the inheritor's own IRA. Rather, it must be in the name of the deceased owner for the benefit of the designated beneficiary of the original account, such as "John Doe, Deceased IRA, FBO, Jim Doe, Beneficiary."

Also—and this is extremely important—the funds must pass directly from the original plan to the IRA, via a trustee-to-trustee transfer.

Another nice feature of this new law is that it also permits the transfer of these plans to inherited IRAs that are held by trusts for the benefit of the non-spousal beneficiaries. This would work especially well for a minor or if you wanted to make sure that your beneficiary rolls the plan to an IRA. The trust would hold the balance of the assets and only the annual required distributions would be distributed.

None of these improvements will work unless you have your beneficiary designations structured properly. This is an excellent time to review your retirement plan beneficiaries and make appropriate changes. And if you find yourself in the position of inheriting retirement plan assets, be absolutely certain to seek professional advice before attempting any portfolio.

The Perfect Recipe

Would you bake a cake with equal parts of flour, eggs, sugar, cocoa, water, and baking powder? Of course not—it would be a culinary disaster. Unfortunately, that's what a lot of people do when they try building their own portfolios with an equal mix of asset classes.

Yes, diversification is important. But even more important is the <u>timely</u> and <u>proportional</u> mixture of assets in your portfolio at any given time. In this market, for example, being over-weighted in large companies is a lot better than being half in stocks and half in bonds.

We recently made a proposal to manage the assets of a large 401-k. The historic performance numbers for the three different portfolios we presented nicely exceeded comparable blended benchmarks, and at a lower level of risk. Nevertheless, a member of the selection committee still wanted to see the performance numbers of the individual funds currently in the portfolios.

That is like asking for the wetness of the water, the sweetness of the sugar, or the yolks of the eggs. By themselves they may or may not have been a good investment at different points in time in different investment environments (or oven temperatures, if you will). But collectively—and in proper proportion—they helped to make a good portfolio.

'Tis The Season To Plan Ahead

Let's face it—everybody wants a piece of you at this time of year. Shopping, family, social obligations, or recitals are layered on top of your normal work and regular activities. But tax planning and thinking about your future also deserve your attention before year-end. This is even more so this year due to some major changes in the law.

Charitable Contributions

If you are at least age 70 ½, you can contribute up to $100,000 directly from your IRA account to one or more charities. This is only for 2006 and 2007. You can use this charitable transfer to meet your minimum distribution requirements. This works best for those who claim the standard deduction, or who would lose deductions because of a phase out of itemized deductions, or who are subject to the 50% limitation on Adjusted Gross Income. If you have questions about whether this is appropriate for you, please give us a call. And if you would like to arrange such a transfer, we need to get the paperwork started by early December at the latest.

This is the season for charitable donations—and trips to the Goodwill, Salvation Army, etc. But it won't be as easy as in the past. For charitable contributions of less than $250, you must keep a canceled check, credit card receipt, electronic funds transfer receipt, or a letter from the charity acknowledging receipt of the contribution and stating its date and amount. For charitable contributions of $250 or more, you'll also need a written receipt from the charity.

If you donated any property such as clothing or housewares valued at less than $250 after August 17, you must keep a detailed receipt from the charitable organization. No tax deduction is allowed for donations of clothing or household items unless they are in good condition. For larger donations, you'll need even more documentation. Donated property worth more than $5,000 requires a qualified appraisal, as do lesser-value objects that aren't in "good" condition.

Retirement Plan Contributions

If you have a retirement plan with voluntary contributions, you need to make your voluntary contribution before year-end. For 401(k)s, if you are under age 50, that amount is $15,000; $20,000 if you are 50 and above. For SIMPLE IRAs the amounts are $10,000 and $12,500 respectively.

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Ron Selected for Medical Economics 150 Best List

Ron was recently selected for Medical Economics Magazine's exclusive list of the *150 Best Financial Advisors For Doctors.* The only other Oregonians to qualify were two others from Portland.

The selection process started six months ago when members of the Salem medical community nominated Ron. It was then followed by an extensive application, and a review of reference letters, medical-based community service, compensation structures, assets under management, experience, past advice given to doctors, and a regulatory background check.

Ron is a founding board member and current president of the Medical Foundation of Marion and Polk Counties, which provides free prescription assistance for those that fall through the cracks. He has also written a monthly financial planning column in *ChartNotes*, the Medical Society's monthly newsletter, since 1997.

The article can be viewed on the Medical Economics website at www.memag.com. Or, we'd be happy to send you a reprint.

The Team Advantage

Ron Kelemen and Mary Way are independent Certified Financial Planner™ certificants. Together with Alex Sheppard they jointly serve their clients as a team with over 37 years of combined experience. Their fee-only practice focuses on wealth planning and management for professionals, business owners, and retirees. Together, they have developed ***The Planning Vision Process®*** and several other unique processes. They are advisory associates of The H Group, Inc., one of the largest independent fee-only registered investment advisory firms in the Northwest with 18 professionals and over $850 million under active management.

About Ron Kelemen, CFP®

In practice since 1981, **Ron Kelemen, CFP®** is a contributing author of three financial planning reference books. His latest one, *Living and Learning—Achieve Retirement and Education Security* was published last by Quantum Press. *Medical Economics* listed him as one of the 150 best financial advisors for doctors. He is active in mentoring and in several local charities, and is frequently quoted in the national press and professional journals.

About Mary Way, CPA, CFP®

Mary Way, CPA, CFP®, is a professional team member on Ron's team for 11 years. She is also a non-practicing CPA with 16 years experience in banking, business, and finance. She sits on the Investment Policy Committee of The H Group, Inc. and is on the board of the Willamette Valley Estate Planning Council. She is active in Salem Rotary, the Financial Planning Section of the Oregon Society of CPAs, and the Oregon Financial Planning Association.

About Alex Sheppard, MBA

Alex Sheppard, MBA joined the practice in March 2005, and has passed his CFP® comprehensive exam. He has a variety of experience in financial services, including four years as an analyst with a major mutual fund company. He is a active in the Salem Area Chamber of Commerce and serves on the board of South Salem Rotary.

The opinions expressed in this newsletter are those of Ron Kelemen, CFP®, Mary Way, CPA, CFP®, and Alex Sheppard, MBA. They do not necessarily reflect those of The H Group, Inc They are general comments that may not be appropriate for every individual. They should not be construed as legal or tax advice. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. All economic information is historical and not indicative of future results.

TEAM UPDATE

This has been our best year ever, and one of our most progress-filled quarters ever! Business growth was very good. But more importantly, we switched to a fee-only business model and made a lot of improvements in our processes. Best of all, we made many new friends and continued to enjoy our existing relationships. Thanks to all of you who helped make this possible.

Lani and husband Jim completed a months-long project of reclaiming a half-acre piece of their property from invasive vegetation. They also wrestled large boulders into a dry seasonal creek bed to create a waterfall, which is flowing nicely now. Lani also helped organized a surprise party for her mother's 80th birthday.

Debbie spent much of the quarter working on the paperwork for some complex tax-free annuity exchanges. In addition to a couple of days here and there, she took a week in August to get a lot of things done around the house, a so-called "working" vacation.

Alex received word that he passed his rigorous 2-day CFP exam. Nationally the pass rate was only 58%. He and his new wife, Virginia flew down to Austin for a former grad school classmate's wedding. They are busy finalizing their wedding plans for the no-holds-barred formal church wedding in Venezuela in January.

Mary was elected to the board of the Willamette Valley Estate Planning Council. She and husband Steve went to Minneapolis for Mary's birthday, followed by a few days in Newport.

But the big news is that they are really excited about the acceptance of their offer on a two-year old home in Silverton, near the Oregon Garden. This reduces Steve's commute from 45 minutes each way to three minutes, while Mary's commute increases only slightly. It has a great view and was built for entertaining. Now, the stress begins. They need to sell their existing home by January 31.

Ron and Alex were quoted in an article in *Wealth Manger* that featured our practice. Ron is still trying to live down the very bald caricature illustration of him. Ron was also quoted in Financial Advisor, the Oregonian, and was selected by *Medical Economics* magazine as one of the 150 Best Financial Advisors for Doctors. He and Kathy participated in a two-week REI Adventures trip, bicycling from Vienna to Venice, through the Slovenian Alps. It was perfect in every way, except that they actually gained weight!

At this time of year we want to express our sincere thanks to our clients, referral sources, strategic partners, venders, and friends.

You all helped to make it a banner year.

Best wishes for 2007!

THE H GROUP, INC. *The Independent Wealth Management Firm*

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Dividends and Capital Gains

The Federal income tax on dividends and long-term capital gains is 15%, and only 5% for low-income taxpayers. These rates were extended to the year 2010 by another law in June. If you have dividend-paying stocks in a margin account and even if you never margined any stocks, you still may not qualify for the lower Federal 15% dividend tax rate if the brokerage firm loaned your stocks to another customer for short sales—a very common practice. Thus, it's best not to have a margin account unless you really use it to margin stocks.

Annual Exclusion Gifts

This year the annual gift-tax exclusion was raised to $12,000. If you wish to take advantage of this, you need to do so by December 31. This is the amount you can give tax-free each year over and above your $1,000,000 lifetime gift tax exclusion. You and your spouse could give, say, your child and his spouse, a total of $48,000 in 2006.

Alternative Minimum Tax

Congress passed minimal AMT relief in June, but for most of our clients, it is probably not enough. With AMT, accelerating deductions before year-end may actually work against you. **As with many other year end tax-planning items plus the ones mentioned above, the best possible tax advice we can give you is to meet with your tax professional just as soon as possible before year-end.**

Minimum IRA Distributions

If you are over 70 ½, you must take your annual distribution by December 31, 2006. The amount is based on your joint life expectancy and the January 1, 2006 account value from all your retirement plans. We believe that all of our clients have either taken theirs or will have received their distribution by year-end. If you have retirement plan accounts elsewhere, you should check to make certain that you have done so. Otherwise, the penalty is 50% of the amount you should have taken. And remember, the last business day of the year for 2005 is Friday, December 29.