FEE-BASED WEALTH MANAGEMENT

CREATIVE PLANNING FOR YOUR FAMILY, BUSINESS AND ESTATE

THE H GROUP, INC.

The Independent Wealth Management Firm™

vision money security

JUNE 2006
VOLUME 16, NO. 2

THE KELEMEN-WAY FINANCIAL PERSPECTIVE

(503) 371-3333
960 Liberty Street SE
Suite 210
Salem, OR 97302
www.planningvisionprocess.com

COMMENTARY BY:

Ron Kelemen, CFP®

Mary Way, CPA, CFP®

Alex Sheppard, MBA

Creators of The Planning Vision Process®

We're Making Changes And Leading The Way

Over recent years, we've been phasing out the commission side of our business while the fee-based advisory side through The H Group, Inc. has grown to represent the majority of our practice. Our clients have clearly told us that they prefer paying fees over commissions. **Thus we have made the decision to transition our investment management business model to a pure fee-only practice, effective July 4, 2006.** As a result, we will drop our brokerage licenses and affiliation with Financial Network, a broker/dealer that exists to facilitate securities transactions. As a fee-only investment firm, we will no longer sell commissionable investment products or receive any related service fees.

Being a fee-only investment firm eliminates potential conflicts of interest and makes it easier to act as a true fiduciary, separating us from the many that do not or cannot.

Improvements in technology, increased client demand for fee-based services, and new client-centered investments have made this possible. And with well over $100 million under management, we can afford the costs of this change. **But more importantly, we believe it is the right thing to do. Being a fee-only investment firm eliminates potential conflicts of interest and makes it easier to act as a true fiduciary, separating us from the many that do not or cannot.** It puts us on the leading edge of where we think much of the financial advisory business is eventually heading. And as a bonus, it opens the door to additional investment strategies and lower-cost mutual funds and removes a variety of redundancies and regulatory burdens.

Most of our clients already work with us on a fee-only basis, so there is little or no change in how we how we do things for them. However, for those that have assets held in a brokerage account at Pershing or with a mutual fund custodian, we will no longer receive account statements and will no longer be able to provide service or advice on those accounts. We encourage those clients to make arrangements with us if they would like us to continue as their advisors.

On a related note, we now have the opportunity to add lower-cost portfolio managers to the investment mix which were previously unavailable to us as representatives of Financial Network. This should benefit everyone. We have also developed additional portfolio options for our larger accounts that can include exchange-traded mutual funds, individual stocks and bonds. These may not be appropriate for everyone, but they give us the added flexibility to custom-tailor portfolios for unique client needs.

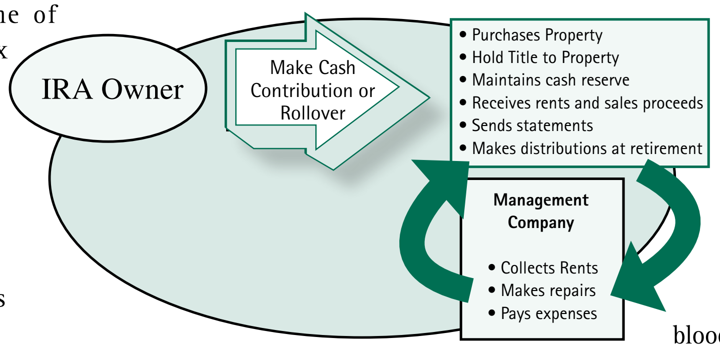
Ron was one of the original founding representatives of Financial Network, which was established in 1983; he was also licensed with its predecessor company in 1981. Mary joined the practice and became licensed with Financial Network in 1995. **We've seen a lot of changes over the years, made a lot of friends, and have enjoyed the stability and integrity of the company. They are like family to us.** So, while we are excited about leaving the commission side of the business, we also conclude our relationship with Financial Network with a sense of gratitude, nostalgia, and good feelings for its employees and other representatives.

All of the above changes would not have been possible without our clients' ongoing business, referrals and – above all – trust. Thank you for helping us reach our long-term goal of being a fee-only investment advisory and financial planning firm much sooner than we would have thought possible. We look forward to the future and are ever more committed to providing the high-level service you've come to expect.

Should You Put Real Estate Into Your IRA Or Retirement Plan?

In the early 80s with gold and precious metals at a high, clients asked if they could put them into their IRAs. The same thing happened with IPOs at the height of the stock market boom in the late 90s. Now that real estate is hot and the stock market is boring, people are asking if it is okay to invest real estate into their IRAs or retirement plans. **The short answer is "yes, you can under certain limitations." But the real question to ask is "should you?"** Most of this analysis revolves around IRAs because they are the most restrictive.

Real estate is a cornerstone of financial planning. It has tax advantages, leverage, and appreciation potential. Under the right conditions in the right market it can be a great investment. And for many people, it provides a sense of tangibility with "bricks to kick" and hands-on control.



But much of these benefits get lost when real estate is put into an IRA. You convert favorable long-term capital gains into ordinary income when the property is sold and you take withdrawals. You waste the ability to defer taxable gain through Sec. 1031 tax-free exchanges. You lose depreciation and interest deductions. If the property you put into an IRA has a mortgage, some of the income it generates will be subject to "unrelated business taxable income" or UBTI for short, even while the property is inside a so-called tax-deferred IRA.

Holding and Managing Property

To hold any asset in an IRA, one must use an IRA custodian. For stocks, bonds, mutual funds, annuities, and bank CDs, the sponsoring brokerage firm, fund company, insurance company or bank is typically the custodian for free or for a very nominal fee. (If you are the trustee of your own retirement plan you can get around the custodian requirement, but you need to take extra caution to act as a fiduciary.) The challenge for real estate is to find a custodian who will agree to hold title to the property, and do so at a reasonable fee.

The next question becomes, **who will collect the rent and pay the bills?** In the words of one real estate custodian's publication, paying the bills yourself and requesting reimbursement from your IRA is not possible because "you are not allowed to take receipt of funds related to your IRA without them being treated as taxable distributions." So that leaves hiring a professional manager to do so, or making arrangements for the bills and rent to be sent directly to the custodian. And that can eat into your profits.

In theory this can work. But as any seasoned real estate investor can tell you, sooner or later the property will need more money than is in the checking account for unexpected repairs, expenses, or vacancies. **Paying the bill yourself is an illegal excess contribution if it exceeds your annual contribution limitation.**

Some seminars and books promote the concept of an owner-managed LLC between the property and the bank custodian to get around this problem. In this instance you, as the LLC manager, control the checkbook. But as tax attorney Natalie Choate, the ultimate guru queen on IRAs and retirement plans notes, the chances for error are greatly increased and Congress may attack this strategy or ban it outright.

Prohibited Transactions

These problems and other issues unique to real estate often fall into the category of prohibited transactions. For example, the property cannot be managed or occupied by:

1) Any family member related by blood or marriage, and that includes you. Nor can it involve anyone with whom you have any personal or business relationship outside the IRA, or
2) Any entity that is owned in whole or in part or that employs or engages anyone in category #1.

So you need to have an unrelated fiduciary—a disinterested person—to manage the asset. **Those promoting real estate within IRA accounts may disagree. But if it were us and whether or not our entire IRAs became disqualified from a prohibited transaction, we would much rather trust our tax attorney (who is accountable to us) than an unaccountable book or web site.**

What About Sweat Equity?

We all know people who have made good money in real estate through "sweat equity." They bought it cheap and worked hard evenings and days off to fix the place up and sell it at a nice profit. Indeed, the inquiries we receive are from people who want to do just that.

But as Natalie Choate points out, adding sweat equity to fix up a house owned by your IRA risks tax evasion charges. You may owe income and self-employment taxes on the income. What you have done is to assign the income resulting from your own labor to another entity, the tax-exempt IRA. In effect, you have made a contribution to the IRA. She cites code sections where your activities could be classified as UBTI, or worse yet, construed as a prohibited transaction in which the entire IRA could be disqualified.

So yes, it is possible to put real property into an IRA, but only if you do it right and are willing to pay the price. Start with competent legal advice—not free "legal advice" from a web site. Follow the rules, hire a good manager and custodian, don't commingle funds, and don't do business with friends and relatives.

Continued on page 4

New Tax Act Has A Few Surprises In Store

The Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005 was signed into law May 17. The bipartisan Congressional Research Office estimates the cost to be $70 Billion. The main purpose was to provide relief for a growing number middle-income families who pay the Alternative Minimum Tax (AMT) and extend the favorable dividend capital gains rates. But like all legislation, it also included some surprises. If you think that any of the provisions below may affect you, be sure to discuss them with your tax professional.

Dividends and Capital Gains

First, the expected. Dividends and long-term capital gains will continue to be taxed at 15% until 2010, instead of 2008. This bodes well for the financial markets. For taxpayers in the 10% and 15% tax brackets, the rate is only 5%. Of course, Oregon taxes are an additional 9%, but it's still a very good deal compared to income earned from salaries and wages. However, because of the AMT, taxpayers subject to it actually pay an effective rate of 21% to 22%.

The Alternative Minimum Tax (AMT)

To nobody's surprise, Congress provided only minimal relief for the AMT for 2006. Generally speaking, those that were close to paying it in 2005 probably won't have to pay it in 2006, as they would have without this legislation. However, this relief is only temporary for 2006. In 2007 we go back to the schedule used in 2000.

AMT Exemption Amounts

Status	2005 Exemption	Without New Law (Year 2000 Levels)	New 2006 Exemptions*
Married Couples	$58,000	$45,000	$62,550
Singles	$40, 250	$33,750	$42,500

*In 2007 we go back to 2000 levels, shown in middle column.

The AMT gets us closer to a flat tax by eliminating the ability to fully utilize certain itemized deductions, tax credits, or fully take advantage of capital gains. Previously, only the foreign tax credit, adoption credit, child credit and saver's credit were to be allowed to reduce the alternative minimum tax in 2006. The Act extends the ability to reduce alternative minimum tax in 2006 to the following credits: dependent care credit, credit for the elderly and disabled, energy-saving credits, tuition credits and certain homeowner credits.

The "Kiddie" Tax

This will be an unpleasant surprise for many parents. Previously investment income exceeding $1,700 in 2006 for children over age 14 was taxed at the child's tax bracket. Now it will be taxed at the parent's highest marginal bracket until the child turns 18. **This changes the game with the custodial UGMA/UTMA accounts typically used to fund college and other discretionary expenses on behalf of a child.** Thus, the income shifting technique of transferring assets to minors will not work. This makes the Section 529 college savings plans a better deal, although converting an existing custodial account to a 529 plan has a few caveats, which we can address more specifically in a private consultation.

Section 179 Small-Business Expenses

Small business owners will be pleasantly surprised to learn that they have until 2009 to expense up to $100,000 qualified business property assets, indexed for inflation. For 2006, the amount is up to $108,000, reduced by the amount by which the cost of the property exceeds $430,000. Otherwise it would have fallen to $25,000 in 2008, with a cap of $200,000.

Continued on page 4

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-based 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-based registered investment advisory firms in the Northwest with 18 professionals and over $800 million under active management. They are also registered with Financial Network Investment Corporation, (unaffiliated with the H Group, Inc.) a national broker-dealer with offices throughout the United States, Member SIPC.

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 just published by Quantum Press in July. He is Past President of the Willamette Valley Estate Planning Council, active in mentoring and in several local charities, and is frequently quoted in the national press.

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 is active in Salem Rotary, the Financial Planning Section of the Oregon Society of CPAs, The Oregon Financial Planning Association, and The Willamette Valley Estate Planning Council.

About Alex Sheppard, MBA

Alex Sheppard, MBA joined the practice in March 2005, and is nearing the completion of his CFP® certification. He has a variety of experience in financial services, including four years as an analyst with a major mutual fund company.

Team Update

As you could guess from the lead article on page 1, we have been very busy transitioning our practice to a fee only investment firm. We sincerely appreciate the patience and enthusiastic support of our clients and other professionals in the community. Adding in our service work at tax time and a large number of new clients, it's been one busy quarter.

Lani has been keeping our schedules full. She and her husband Jim went to Maryland for their 30th anniversary to visit family and be with their young grandchildren. She was also blessed with another new granddaughter in May. And if it's spring, you can find her in her garden off hours.

Much of our transition work has fallen on **Debbie,** who has managed to stay on top of all the paperwork. She and husband Bob attended their daughter's graduation from the University of Portland, and will soon start enjoying the tax-free raise that comes when your last child graduates from college. They also went to Prescott AZ to visit their son, Pete, who is a flight instructor.

Alex passed his CFP exam on Estate Planning. He is now studying hard for the two-day final exam in July—just immediately before his engagement ceremony in Eugene. He made a quick trip to New York to visit his fiancée, Virginia, and has been kept busy with South Salem Rotary and a number of recent financial planning cases.

Mary, working closely with Debbie, has kept the transition process moving along. This quarter, she has stayed close to home, enjoying gardening and yoga, but she and husband Steve managed to make a quick trip to Seattle. She was nominated to serve on the board of the Willamette Valley Estate Planning Council, starting next September.

Ron's article on the psychological issues of retirement was published in **Research Magazine,** and he was nominated to be on **Medical Economics Magazine's** national list of the top 150 financial advisors for doctors. While he was busy with the Medical Foundation's Jean-Michael Cousteau's fundraiser, wife **Kathy** was heavily involved with Salem's first film festival. They "did" New York before heading to Boston for daughter Shanti's graduation from Boston University. She already has a job with Investors Bank and Trust Co. in Boston. Daughter Skyler is having a wonderful time on her cross-country bicycle trip with Bike and Build, stopping to work on Habitat for Humanity projects along the way.

Should You Put Real Estate Into Your IRA Or Retirement Plan?... continued from page 2

Keep it simple

We believe in diversification—both in asset classes and in ownership structure. So keep your IRA and retirement plan in the more traditional, liquid, and low cost assets. Enjoy the tax deduction and tax deferral. To diversify your IRA and retirement plan with real estate, consider real estate investment trusts (REITS), mutual funds that invest in them, real estate related companies, trust deeds, and mortgages, such as GNMAs or funds that invest in them. Keep your real estate outside your IRA and retirement plan to take full advantage of the tax benefits real property offers, plus the opportunity to work up a sweat and get your hands dirty.

THE H GROUP, INC.
The Independent Wealth Management Firm™
The Kelemen-Way Financial Perspective

Ron Kelemen, CFP®
Mary Way, CFP®, CPA
P.O. Box 3758
Salem, OR 97302-0758

ADDRESS SERVICE REQUESTED

New Tax Act Has A Few Surprises In Store... continued from page 3

Roth Conversions

This is a big surprise, and whether or not it is a pleasant one depends upon your generation, income level, and investment assets. Previously, only those with adjusted gross incomes less than $100,000 could convert their IRAs to a Roth IRA. After the later of age 59 ½ or five years, the money can be withdrawn tax-free. In 2010, the $100,000 income limit will be removed. Anybody, regardless of income level, can convert, and spread the tax bill equally over the next two years, if they wish. They also lock in today's lower income tax rates, which are scheduled to sunset in 2010.

This suggests a strategy: Do what ever it takes to fund an IRA each year, whether it is fully deductible or not. (The limits are $4,000 for those under age 50, $5,000 for those above.) Then in 2010, if an analysis shows that a conversion is best for your objectives, convert your IRA to a Roth, paying the taxes with funds outside the IRA. Those higher income taxpayers who made non-deductible IRA contributions will have little or no income taxes to pay at the time of conversion. The assets continue to grow tax deferred and tax free—<u>forever.</u>

The Congressional Budget Office estimates that the Treasury will take in $7 billion in taxes from wealthy individuals converting their IRAs to Roth IRAs between 2010 and 2015. But when you consider the long-term nature of IRAs and stretch IRAS, how much investment growth will never be taxed at a time when Social Security, Medicare, the deficit, and retiring baby boomers will place an even greater burden on succeeding generations? In our opinion, this is "numbers engineering," at its worst, a short-term governmental income fix, not too much unlike corporations focusing only on the next quarter's financial results. **As a personal planning strategy it makes sense. But does it make sense for our children and grandchildren? They could be in for the biggest surprise of all.**