Comprehensive FINANCIAL PLANNING INC.

April 9th, 2014

Here is our newsletter for the 2nd Quarter of 2014.

The Markets:
The 1st quarter was relatively quiet for the markets. U.S. equities were up less than 2%, developed foreign markets were basically flat and emerging markets continued their underperformance by being down 1.1%. Fixed income markets did ok with the Vanguard total bond Market Index up 1.9%.

Our portfolios all had small positive gains for the quarter and will continue to be highly diversified and designed to have low volatility in up or down markets. In February we rebalanced our portfolios back to their target allocation by taking some profits in funds that have done well and bought more of the funds which have lagged. We also increased our allocation in the Litman Gregory Master Alternative Fund in our more conservative portfolios as we believe it will provide a good alternative to the traditional bond market going forward.

Annuity Rescue Part 2: What Does a Guarantee Guarantee?
Recently we helped a client couple evaluate an existing annuity contract they acquired in 2004 while they were both working. Now that they are retired they wanted to see what, if anything they should do with it. I was able to increase their monthly income from the annuity by 20% for their lifetimes by finding a better option than their current annuity. This is really important as I see so many clients with annuities they don't understand and are not serving them well. I know this won't be easy reading but hang in there.

Annuities are probably the most misused and oversold product on the market. Back in our July 2008 newsletter we wrote about the different types and our thoughts on annuities in general. Here is a link: http://www.compfinancial.com/newsletters/2008q2-newsletter.pdf

My clients were in a variable deferred annuity starting in 2004 from a major insurance company which had been invested mostly in the stock markets using mutual funds. It had a Guaranteed Minimum Income Benefit (GMIB) rider which increased the GMIB benefit amount by 5% per year. Most people think this guarantees you a minimum 5% per year return on your investment. This simply is not true. There are two balances inside the annuity. The first is the real investment balance which is dependent upon the performance of the mutual funds, less the additional contract fees and the rider fees for the GMIB benefit which totaled 1.3% per year. The second is the GMIB benefit value which is the starting value plus 5% per year going forward. If you want to simply withdraw the funds from the annuity over time or in a lump sum or rollover you get the investment balance, not the GMIB balance. You only get access to the GMIB balance if you annuitize the contract and take monthly income for life. So if the investment balance increases less than 5% per year you could annuitize the GMIB balance if it is larger than the investment balance and presumably get a benefit from the GMIB rider.

We contacted the insurance company and asked them to quote us a monthly income the client could receive by annuitizing their balance. Late last year the investment balance became the larger of the two and it was used to calculate the monthly income. I then went to the Income Solutions platform and got quotes from several insurance companies on an identical annuity funded by transferring the existing annuity balance (all annuities have surrender charges that last up to 10 years and fortunately theirs had expired). For the exact same terms the highest quote for the new annuity was 20% higher than the income from the existing annuity.

Why is the new annuity generating more income? The answer is twofold. First, the new annuity is offered with only a 1% transaction cost on the fee-only platform I use. They do not pay me. The existing annuity was sold by a salesperson paid a commission which reduced the income left for the client. Second, there are many factors which determine the income, <u>not just the balance annuitized</u>. Additional factors include how long the insurance company assumes the client lives to receive payments and the interest rate assumed; a higher rate generates a higher income. It is noteworthy that the new annuity still paid a higher income even though current interest rates are lower than they were back in 2004 when the existing annuity was purchased.

So the devil is in the details. Words like "guaranteed income for life" sells a lot of these products but all that is guaranteed is the salesperson will get their commission at the sale.

Give the Gift That Keeps On Giving

Many of my clients have charitable goals and I help them evaluate the options for giving. There are many ways to benefit your favorite non-profit organization and at the same time provide financial benefits to you. Here is an overview of some of the options available.

<u>Outright Gift</u>

This is the simplest way to gift by simply writing a check. The gift qualifies for a charitable contribution as an itemized deduction to reduce your federal and state income taxes.

To save even more you could gift shares in stock, mutual funds or other assets that have appreciated in value since purchase. By gifting an appreciated asset, not only do you get a tax deduction based on the market value at the time of the gift, you also eliminate the capital gain tax you would have paid if you sold the shares and gifted the proceeds. You can actually save as much as 50% of the value of the gift. For example, say you have shares in ABC Corporation that is worth $10,000 today that cost you $1,000 to purchase. Now say you are in a marginal tax bracket of 35% for federal and state income tax purposes. If you gift the shares you could reduce your income tax by 35% of $10,000 or $3,500. You would also avoid the capital gain tax of 15% (or 20% if you are a high earner) on the gain of $9,000 for another $1,350 in savings resulting in a total savings of $4,850. This enables your $10,000 gift to only cost $5,150 out-of-pocket.

Donor Advised Fund

This vehicle enables you to set aside a large sum up front that you can donate from for many years in the future. It allows donors to recognize a tax deduction for transfers made to the fund in the current tax year while transfers to individual charities can be made in the current or future years. In a typical DAF, you would contribute a lump sum into the fund which is managed by a trustee to ensure all the IRS rules are followed. Under your direction and at a time of your choice, the funds are distributed to qualified charitable organizations. You would receive a current charitable donation tax deduction on market value of the assets up front when you contribute to the fund. This allows you to get a large deduction up front and works well if your tax bill is unusually high in the current year and you are looking to maximize your tax savings in the current year. It also can also greatly reduce the paperwork and time required to track if you give to many different charities.

Trustee fees run from 0.6% to 1% per year of the assets. Most local community foundations have these for your local charities, including one here in Durango. You can also set one up at TD Ameritrade and have me manage the funds for the benefit of the charities. The fund can be funded with highly appreciated stock like the outright gift to avoid any capital gains taxes. The proceeds can then be reinvested in a diversified portfolio of mutual funds with all income sheltered from taxation and gifted over many years.

Conservation Easement

If you own land with important natural or historic resources, donating a voluntary conservation easement can be one of the smartest ways to conserve the land you love, while maintaining your private property rights and possibly realizing significant federal and state tax benefits. This can include ranch or farm land or simply open space important for wildlife or water conservation. Recent legislation has extended the tax incentives thru 2015. The federal incentive includes a charitable tax deduction up to a limit of 50% of your adjusted gross income per year. It also allows qualifying farmers and ranchers to deduct up to 100% of their income. Any gift over the limits can be carried forward to reduce your taxes for up to 15 years.

If this is not enough incentive Colorado has a tax credit which can be used with limitations and exclusions. If you don’t pay that much tax in one year to Colorado you can continue to use the credits up to 20 years going forward. You will need to consult a CPA to determine your tax savings.

Doing an easement can be and long and expensive process where you will need a qualified conservation organization to donate the land to, an appraiser, attorney and accountant to work out all the details. A client I recommended look into doing an easement recently completed one spending about $25,000 to complete the transaction. The tax savings will be around $250,000. Not a bad return on the investment.

Charitable Remainder Trust

The CRT is really not practical unless you want to gift $200,000 or more due to the additional costs and complexity. In a typical Charitable Remainder Trust (CRT), you would donate a remainder interest in an asset to a charity. You would receive a current charitable donation tax deduction, remove the asset from your estate, and retain an income interest in the asset over some period of time. The trust can be funded with highly appreciated low-yielding assets. Because the CRT is exempt from taxation, the asset can be sold tax-free, avoiding the capital gain tax. The proceeds can then be reinvested in a diversified portfolio of mutual funds.

The asset is removed from the donor's estate for estate tax savings, and the donor retains income interest in the trust for up to 20 years before transferring irrevocably to the designated charity or charities. An attorney will draft the trust for a fee. The donor can be the trustee of the trust; however this could cause problems if the trustee powers are not restricted properly. There are also many rules governing the income payout acceptable, minimum remainder left for the charity, etc. Taxation of income from the trust has to follow a set of complicated rules which specify taxation of all ordinary income first, capital gains second, etc.

In closing, we just passed our 10 year anniversary in business. Thanks for your business and referrals and let me know when I can help with anything.

Sincerely,

Stan Johnson, CFP(R)
Comprehensive Financial Planning, Inc.
Registered Investment Advisor