



Do You Know Where Your Assets Are?

You already understand the benefits of asset allocation—the practice of splitting investments among different asset types such as large-capitalization stocks, small caps, and several kinds of bonds. Diversified portfolios tend to experience less volatility and over the long haul may outperform more concentrated holdings.

But another asset issue is also important though less well known. Which investments you choose to hold in taxable or tax-deferred retirement accounts could affect your overall portfolio's performance. Studies have shown that getting the location right may boost returns by almost a third of a percentage point annually. And though that may not seem like much, over decades it can make a big difference in the size of your nest egg.

Deciding whether a certain asset should go into a taxable or tax-deferred retirement account depends on two factors—the tax efficiency of the investment and the size of its returns. The higher the return, the more significant the benefits of proper placement, says Gobind Daryanani, co-author of a study on asset location published in the January 2005 issue of the *Journal of Financial Planning* and now president of iRebal, which develops portfolio rebalancing software.

Assets that have a history of delivering nice returns—such investments may include individual stocks, stock index funds, exchange-traded funds (ETFs), and tax-managed stock funds—are good candidates for taxable accounts. These investments keep capital gains distributions to a minimum, and, as held for at least a year, payouts are taxed at the favorable 15% rate for long-term capital

gains. In contrast, money drawn from tax-deferred accounts during retirement is taxed as income at rates as high as 35%.

Moreover, taxable accounts provide the opportunity for tax loss harvesting—taking investment losses to offset gains, thus reducing your tax bill. Daryanani's work indicates that tax loss harvesting may add another 10 to 20 basis points—0.1 to 0.2 percentage points—to your annual returns.

Obviously, tax-advantaged municipal bonds also should go into taxable accounts. It doesn't make sense to shelter income that is already exempt from federal, state, and often local income

Which investments should you place in taxable versus tax-deferred accounts?

taxes in a tax-deferred retirement account.

Candidates for tax-deferred retirement accounts include high-return investments that tend to be taxed at steeper rates. That may include actively managed stock mutual funds, REITs, commodities, and absolute return investments. For example, because active managers tend to make frequent trades, their funds may distribute significant capital gains, many of which may be classified as short term and taxed at regular income rates. It pays to defer taxes on such gains as long as possible.

REITs also may be well suited for

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Is Your Business Integrated With Your Personal Finances?

Many people who start their own business are motivated by a desire to set their own course. However, they are often so overwhelmed by the day to day chores of running a business that they neglect their personal financial plan.

As a business owner, it's up to you to make sure the business is covered by the right insurance and watch your cash flow. You've got to train your employees and manage them, and you've got to keep an eye on the competition. With so much to do, it's understandable why you might neglect something as important as your own personal financial plan—understandable but also unacceptable.

If you're too busy to take care of your family's personal financial plan, let us help you. A financial advisor can help you focus on what's important and create a disciplined plan for you. Moreover, we can determine how to integrate your business with your personal finances.

Are you taking full advantage of SEP and SIMPLE IRAs or the so-called "Solo" 401(k) retirement plans? Would a defined benefit plan make more sense for you? Are you paying too much for a line of credit in your business? Is your ownership structure correct? Should you consider placing an interest in your company in a trust for estate planning purposes? Is your succession plan properly funded?

Get answers and take care of your own personal finances. Please give us a call.

Some Home Loans May Not Be Deductible

Have you refinanced, taken out a second mortgage, or used a home-equity line of credit? If you're subject to the alternative minimum tax (AMT), you may not be able to take a tax deduction for all of the interest on such loans.

All taxpayers must calculate their taxes under two sets of rules, for normal income tax and the AMT. You pay the higher tax. Even if you're not subject to AMT rules now, you could be soon. The number of AMT taxpayers is predicted to soar from about 3 million in 2004 to more than 11 million in 2005, and will likely continue to rise throughout the decade.

One deduction not allowed under AMT rules is for interest paid on home-equity loans. Forget what lenders mean by that term—as far as the Internal Revenue Service is concerned, home-equity debt is any loan secured by your residence but used for something other than buying or improving the home. Suppose you've been approved for a line of credit based on your equity in the property, and you draw out money to cover tuition at your daughter's private college. Or you take a second mortgage at today's

reasonable interest rates and use the cash to pay down more expensive credit card debt. In both cases, if you pay AMT, you can't deduct the interest, because you didn't use the money to purchase or

Don't set yourself up for a nasty surprise—disallowance of part or all of the tax deduction for a home equity loan

fix your home. In contrast, the regular rules permit writing off the interest charged on up to \$100,000 of home-equity debt, assuming the loan was made after October 13, 1987. All interest on older mortgages is fully deductible for both regular and alternative tax purposes.

The waters become muddier when refinancing is involved. Suppose you and your spouse

borrowed \$200,000 several years ago to buy your home. You still owe \$160,000, but the property has appreciated substantially and interest rates have fallen. So you decide to refinance \$240,000. The first \$160,000 of your new loan replaces the remaining debt on your purchase, and interest on that amount is deductible under AMT rules. But what about the other \$80,000, which accounts for a third of the refinanced amount? Use it to pay for non-home-related expenses say, a luxury cruise and new automobiles—and a third of your interest won't be deductible in years you pay AMT.

Even if you refinance only what you owe on your original loan, closing costs could pose a problem. Suppose you take a new loan for the \$160,000 balance on your old \$200,000 mortgage, and the lender charges \$5,000 to process the transaction. If you pay the closing costs out of pocket, you can deduct all of the interest on the new loan, even under AMT. But if you finance those costs, and thus borrow \$165,000, AMT rules stipulate you can deduct only the interest on \$160,000—because the other money didn't pay for a home purchase or renovation. ●

Creating The Road Map To Guide Your Financial Journey:

If you were planning a car trip across the country, you could take off in the general direction you want to go and feel your way along, guessing which roads to take and what to do about the inevitable detours. But why do that when you could just get a map and chart your course, creating a strategy to get from here to there? In investing, that road map is called an investment policy statement. It provides a systematic way to chart your investment course to reach your life goals.

An investment policy statement sets out the types of investments and

returns you'll need, the risk you are willing to accept, and how long you plan to stay invested. Your investment policy should be coordinated with your tax situation and with your plans to leave money to your spouse, children, or other heirs when you pass on.

When financial markets take a turn for the worse, it's human nature to lose direction. When stocks fall for three years and lose almost 40% of their value, it's natural to get nervous, react emotionally, and think about yanking your money. Historically, however, these unpredictable market plunges are often

followed by equally unpredictable and explosive rallies, and those who pull out of the market after a drop can easily miss out on the bounce back.

If you pull out your investment policy statement in the middle of market turmoil, it will remind you of the course you charted in a less emotional time. It will take you back to your long-term strategy. So, instead of making a detour when the market turns, you'll be much more likely to stick with your strategic investment decisions and stay on course.

Your investment policy statement

Avoiding The Snare Of State Death Taxes

You may have cheered when the 2001 tax act dramatically raised the amount you can shield from federal estate tax, but many state lawmakers did not. Numerous jurisdictions had tied their own “death taxes” to the federal system. So when Congress increased the IRS exemption from \$675,000 per individual, legislators in such states foresaw dented revenues. Many states have since decoupled their laws from Washington’s rule book and established exemptions considerably less generous than the federal one, which jumped to \$2 million on January 1, 2006. As a result, your estate could end up on the hook for state inheritance taxes even if the IRS is owed nothing.

Crafting an estate plan that minimizes both federal and state levies is complicated by the ongoing changes to IRS rules—and by the likelihood of further legislative adjustments. For now, the federal exemption surges to \$3.5 million in 2009. The following year, the federal estate tax goes away, but in 2011 it reappears with a scaled-back exemption of \$1 million.

Married couples may face the biggest problem. Traditionally, they’ve sought to avoid estate tax when the first spouse dies and to pay as little as possible at the second death. They may draft estate planning documents

creating a bypass (or credit shelter) trust at the first death. The trust inherits assets equal to the federal exemption and thus avoids estate tax liability. The remainder of the property goes to the spouse, who may inherit an unlimited amount estate tax-free.

Suppose a husband and wife, each with \$2 million in assets, have such a plan in place. If the husband, say, dies before the end of 2008, the plan would direct all \$2 million of his assets to the bypass trust. It can be designed to pay income to the surviving spouse for life, yet the assets won’t be considered part of her estate. The value of her estate, assuming her assets don’t gain or lose value, remains at \$2 million.

But this traditional strategy could incur state tax at the first death if the IRS and state exemptions are different. New York, for example, currently exempts \$1 million. In this example, half of the amount sent to the bypass trust would be immediately subject to Empire State tax. Albany’s take: \$99,600. The state tax bill would be even larger if the first death occurred in 2009, when the difference between the federal and state exemptions widens. What to do?

One potential solution is to create an insurance trust and, taking gift tax consequences into account, fund it with money to buy a life policy.

The insurance death benefit could be used to pay the state tax due at the first death.

Another strategy is to sidestep state tax for now by funding the bypass trust with the state tax-free amount, rather than the higher federal exemption. Yet while this may save state tax in the short term, chances are the estate would eventually have to pay the full state levy. Meanwhile, because the survivor’s estate is larger, a bigger federal tax bill could also result.

Suppose the New York couple adopts this approach. The husband’s will directs \$1 million to the bypass trust, and \$1 million to his wife. Her estate then totals \$3 million—her initial \$2 million, plus \$1 million from her husband. Assuming she dies before 2009 and there is no change from current law, her estate would owe federal tax on \$1 million (\$3 million estate, minus \$2 million federal exemption), a liability of more than \$400,000. And though the estate avoided state tax at the first death, when the wife dies, New York state will tax the estate on \$2 million, not \$1 million. The state tax has merely been postponed. That’s true even if the wife happens to die in 2009 or 2010, when a \$3 million estate would owe no federal estate tax.

Given the uncertainty about the ultimate fate of the federal estate tax and the likelihood of further changes at the state level, flexibility continues to be a prime estate planning virtue. One solution is to include disclaimers, which allow heirs to refuse inherited assets. A survivor might use disclaimers to control the size of her estate and the amount that pours into the bypass trust. Another option, a qualified terminal interest property tax election, gives an executor leeway to choose the best course at the time.

If your estate plan hasn’t been reviewed recently, you’d better dust it off. In the current environment, benign neglect could be very expensive. ●

Your Own Investment Policy Statement

also can help you make sure your portfolio is invested consistent with your preferences. If you’d rather not invest in foreign markets or want a “socially conscious” portfolio that avoids stocks of gaming companies, tobacco-makers, defense contractors, or alcohol producers, you can write that into your investment policy.

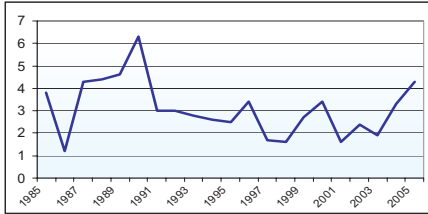
If you are averse to risk, then your investment policy statement should articulate that, too. You could expressly prohibit investing in riskier zero coupon bonds, illiquid assets, or other high-risk opportunities.

The statement is also practical for estate planning reasons. With most

married couples, one spouse usually handles all or most of the financial issues, including how their investments are managed. If that spouse dies first or becomes ill and can no longer manage financial affairs, the surviving spouse can use the policy statement as a roadmap for investing.

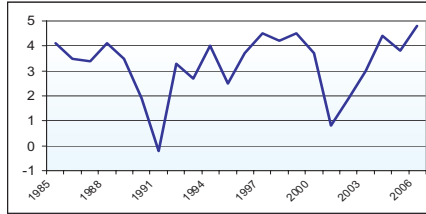
One final benefit of an investment policy statement: When a securities salesperson calls you during dinner and tries to sell you a sure thing in an Alaskan pre-fab igloo manufacturing partnership, just send him a copy of your investment policy. You probably won’t ever hear that pitch again. ●

Economy Watch: 2nd Quarter 2006



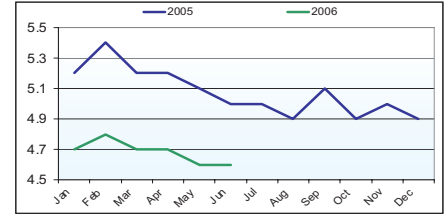
U.S. Economic Growth

After a strong start, the economy started to show signs of slowing in Q2. Preliminary estimates for the quarter indicated that that economic growth slowed by more than 50% to 2.5% from 5.6% in the first quarter.



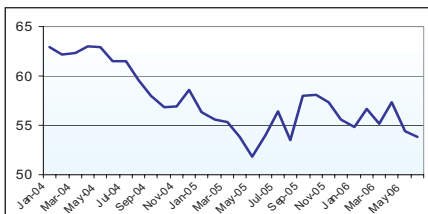
Inflation

The Consumer Price Index picked up momentum in Q2 as energy prices continued to spiral up to over \$70 a barrel. At 4.3%, the index increased speculation of inflationary pressure and further Fed tightening.



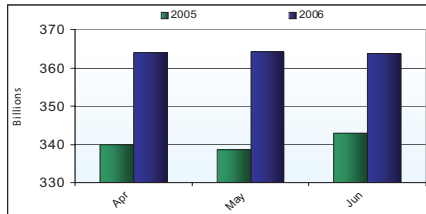
Jobs

The unemployment rate took a slight dip and ended the quarter down by 0.1% to 4.6%. In spite of signs of a slowing housing market and lowed GDP growth, job growth continued to show signs of robust economic expansion.



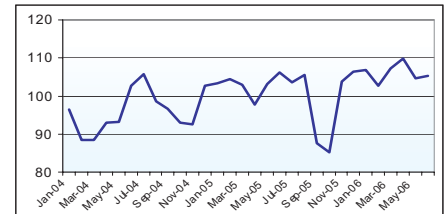
Manufacturing Growth

The Institute of Supply Management's manufacturing growth index, continued to show signs of expansion. The index which has a threshold value of 42, ended Q2 down by 3.5 at 53.8 — still pointing to growth.



Consumer Spending

Retail sales remained fairly flat during the quarter and ended Q2 up by more than 5% from the 2005 comparable period. The majority of the year-over-year increase was attributable to higher prices at gasoline stations.



Consumer Confidence

Consumer confidence took a dip early in Q2 and ended at 105.4—4.4 points lower than the index value at the quarter start. The index continues to express consumer optimism but with an added degree of uncertainty.

Data for the CPI, Unemployment Rate and Non-farm Payrolls are from the Bureau of Labor Statistics. Data for the GDP are from the Bureau of Economic Analysis. The Purchasing Managers Diffusion Index is a release of the Institute of Supply Management. Retail spending data are from the Bureau of the Census. Data for Consumer Confidence comes from the Conference Board.

Where Are Your Assets?

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retirement accounts because most of their payouts are taxed as income. Commodities funds and absolute return strategies tend to generate plenty of short-term capital gains, which are taxed at ordinary income tax rates as well.

And taxable bonds? Given that interest income is taxed at income rates, some researchers believe it makes sense to put taxable bonds in retirement accounts. However, Daryanani contends it doesn't much matter where you put assets such as bonds that provide relatively low returns. The lower the returns, Daryanani says, the less asset location matters.

Some financial advisors contend asset location decisions should be a

matter of timing. Fill retirement accounts first, they suggest, then turn attention to taxable accounts. According to this argument, investments such as actively managed stock mutual funds—often earmarked for taxable accounts—may be a good first choice for tax-deferred retirement accounts, according to R. Benjamin Cribbs, certified financial analyst at The Vanguard Group. Taxable bond funds could go next into a retirement account, with tax-managed stock funds, broad market index funds, ETFs, and municipal bonds funds directed into taxable accounts.

Daryanani's research found that a \$1 million portfolio divided between taxable and tax-deferred accounts depending on each investment's tax efficiency and returns would have grown to \$5,485,881, after taxes, in 20 years. In contrast, a

portfolio that used the same asset allocation in both taxable and tax-deferred accounts would have been worth \$367,652 less.

Obviously, if you have all of your savings in tax-deferred retirement accounts, you don't need an asset location strategy. Also, the optimal location for each investor's assets depends in part on that investor's individual tax situation, investment holding periods, and frequently changing tax laws. But if you have both taxable and tax-deferred investments, paying attention to what assets you hold in which kind of account can make a difference in after-tax returns. ●

Paying attention to the proper placement of investments in taxable versus tax deferred retirement accounts can boost long-term after tax returns.

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