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With Many Now In Despair, Asset Protection Is Wise

Even in the best of times, people with significant assets may find themselves on the wrong end of a lawsuit. Most physicians, for example, will be sued for malpractice at least once during their careers, and they pay high premiums for liability insurance, which may not cover the entire exposure. Other professionals and business owners also are frequently dragged into court, and adverse judgments may put family assets at risk.

But if the wealthy are targets of lawsuits even when the economy is strong, they're all the more vulnerable these days, when financial desperation may motivate people to take a legal shot at anyone for any reason. And if a judge or jury sides with the plaintiff, a defendant could lose business interests, investments, or other property.

In some states, the simple act of purchasing life insurance and annuities can help to protect assets. But whatever strategy you follow, you need to act before there's a problem. If you're already being pursued by creditors or embroiled in a lawsuit, the courts may disregard moves to shield your property.

Consider these possible asset-protection strategies and vehicles:

Transferring property. One simple way to protect assets is to give them away. You can transfer as much property as you like to your spouse (if a U.S. citizen) free of estate or gift tax, and under the annual gift tax exclusion, you can also make gifts of up to $13,000 a year to anyone else. Moreover, in 2011 and 2012 you are entitled to a lifetime exemption of $5 million (applies to estate, gift and generation-skipping taxes).

Forming a corporation. If your fortune is tied to business interests, a traditional method for avoiding personal liability is to establish a C corporation. In the absence of fraud, you normally won't be liable for corporate debts, but you also aren't necessarily protected against professional liability if you are a professional. The personal liability protection of a C corporation is not impregnable, however, as the courts have increasingly allowed persistent plaintiffs to "pierce the corporate veil" and reach a defendant's personal assets.

Other corporate variations, such as S corporations and limited liability companies (LLCs), offer protections similar to those of a C corporation, and those alternative business structures may give you tax advantages. Generally, a C corporation is taxed twice—the business pays income tax, and then you're taxed on the dividend you receive—whereas S corporation shareholders and LLC members get only a single tax bill. The LLC format, compared with the older S corporation, has fewer restrictions, but may have higher taxes in some states.

Owning assets jointly. Another long-standing asset protection strategy is to title property as joint tenants with your spouse or another family member. If assets are owned by "joint tenants with rights of survivorship"

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Life In A Box

Remember when you were a kid, things were simple, life was good? Everything you owned could fit into a box. All your worldly possessions in one safe place. It made you feel secure. Time passed, you collected more things, more boxes. Life became less simple. Here's a question: do you know where everything is and what everything is worth? If you don't know, you should.

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We'll provide you up-to-date data to evaluate your options, and with a click, you can print out reports to see your complete financial picture. We have the tools to connect you with everything you own, so you know what everything is worth, all in one place.

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John

Veil Lifted From Municipal Bond Market

Municipal bonds have long been prized for their tax-exempt status and because they aren't as likely to default as are corporate bonds. However, the default rate has skyrocketed amid the global economic crisis, increasing the need for transparency in this specialized market.

Regulators have responded with three new measures designed to help investors navigate the complex world of municipal bonds, which are debt instruments issued by cities, counties, and local agencies such as school districts, publicly owned airports, and development agencies. Munis pay for projects such as hospitals, schools, public buildings, roads, and utilities. Bonds that fund programs for the public good are usually exempt from most taxes, including federal. While mutual funds, banks, hedge funds, and corporations all invest in the $2.7 trillion municipal bond market, 64% of muni investors are individuals.

In 2008, 140 issuers defaulted on $7.6 billion in muni bonds as states and cities across the nation faced massive budget deficits. That compared with just $226 million in defaults during 2007. This trend, which is likely to continue, makes munis a bigger risk, and means investors need timely information more than ever. Here are three ways the federal government is bringing more transparency to the muni market.

Putting it all online. Over the summer, a new website called Electronic Municipal Market Access (EMMA, at http://emma.msrb.org) began offering free information, from financial filings to trading records, on most of the 1.2 million outstanding municipal bonds. Operated by the Municipal Securities Rulemaking Board (MSRB), the site allows investors to research municipal bond issues and keep track of new filings. In the past, investors often were not aware if an issuer had failed to file statements or had taken some action affecting a bond or its rating. The site also offers educational materials.

Into the open, and quickly. The Securities and Exchange Commission has proposed a new rule that would force issuers to disclose on EMMA any change in their financial status within 10 days. That would include changes in an issuer's credit rating, withdrawals from reserve funds, and late payments of principal or interest. In the past, investors have complained about delays in receiving this information and issuers' failure to file required disclosures.

Turning up the heat. The Financial Industry Regulatory Authority (FINRA) is looking into the sales practices of brokerage firms that sell municipal securities and has asked for detailed information on business conducted during 2009.

All of these actions should make for a more transparent municipal bond market. If you have questions about municipal bond investing or your muni holdings, please give us a call.

The term "municipal bonds" is typically used to describe all tax-exempt bonds. Although such bonds are commonly referred to as "tax-exempt," there are numerous federal and state tax consequences associated with the acquisition, ownership, and disposition of such bonds. The tax-exempt status of municipal bonds does not extend in all instances to the Alternative Minimum Tax. Please contact your tax advisor for more information.

Do A Direct 401(k) To Roth Rollover

In the not-so-distant past, it wasn't particularly easy to roll over funds from a 401(k) plan to a Roth IRA, which can provide tax-free income during retirement or for your heirs. Now, it's a relative snap. What's more, the IRS has provided new guidance on how to complete this maneuver.

Prior to the Pension Protection Act of 2006 (PPA), it took two steps to complete a 401(k) to Roth rollover, and it was possible only if your income didn't exceed a specified limit. First, you transferred funds from your 401(k) to a traditional IRA. Next, you converted the traditional IRA to a Roth, paying income taxes on the amount of the conversion. But you could do this only in a year in which your modified adjusted gross income (MAGI) didn't exceed $100,000.

The PPA fixed part of the problem. Beginning in 2007, you were allowed to roll over funds directly from a 401(k) plan to a Roth, bypassing the traditional IRA. But you still might have been blocked by the $100,000 limit.

That impediment no longer exists. Based on a tax law change that took effect in 2010, you may now convert to a Roth regardless of your annual MAGI. And, for conversions completed in 2010, you can split taxable conversion income between 2011 and 2012. That lets you postpone the tax hit of converting to a Roth, and you may pay less overall if the smaller taxable amount keeps you out of a higher tax bracket.

The IRS recently issued rulings clarifying aspects of a direct rollover. The guidance included these points:

• You can convert to a Roth IRA from retirement plans including 401(k)s, 403(b)s, and 457(b)s.

• A direct rollover to a Roth isn't subject to automatic 20% withholding. But you can agree to voluntary withholding.

• Beneficiaries may make rollover

Managing A Concentrated Stock Holding

The bear market was full of reminders of the perils of holding concentrated stock positions. In the financial sector alone, many former titans saw their share prices fall precipitously (and a few disappeared altogether). Though concentrated positions sometimes also provide extraordinary gains, a broad mix of investments holds a lower probability of loss. That doesn't mean you should immediately sell a concentrated stock position and replace it with a diversified portfolio—there are tax costs and other factors to weigh—but it does argue for managing them wisely.

Even if you discount the likelihood that a particular holding might lose most of its value, stocks' volatility could limit your investment gains. "The Hidden Cost of Holding a Concentrated Position[1]," a recent study by investment firm Robert W. Baird & Co., compares a hypothetical stock-and-bond portfolio to the 272 stocks that were in the Standard & Poor's 500 stock index from March 31, 1999 through March 31, 2009. The hypothetical portfolio, with 60% of assets in a broad mix of stocks and 40% in taxable bonds, outperformed most of the individual stocks, whose average volatility was four times that of the diversified holdings. (Volatility, often measured in terms of standard deviation, considers changes in the market price of an investment; the more sharply the price tends to rise and fall, the greater the stock's volatility.) And while 160 of the stocks failed to keep up with inflation—and 104 lost 20% or more—the hypothetical diversified portfolio produced a 45% gain for the decade, according to the Baird study.

One reason the diversified portfolio did so much better has to do with volatility's effect on compounded investment returns. The Baird study considers two hypothetical holdings that produced the same average annual returns during a two-year period but had very different levels of volatility. The first investment gained 50% the first year but lost 30% in year two, for an average gain of 10% and a volatility of 40%. The second investment gained 15% and 5%, respectively—also an average 10% gain but with volatility of just 5%. That makes a big difference in the performance of a $1 million investment in each holding. The first would jump in value to $1.5 million after one year before dropping back to $1.05 million after the second year, for compounded annual growth of 2.5%. The second investment, in contrast, would have been worth only $1.15 million after one year but $1,207,500 after two—a compounded growth rate of 9.9%.

Five Ways To Manage A Concentrated Stock Position
1. Avoid similar holdings in the rest of your portfolio
2. Divest your shares gradually to stretch tax liability
3. Fund charitable goals with part of your holding
4. Put a portion of the stock into an exchange fund
5. Use a 10b5-1 preprogrammed selling program

So if diversification tends to provide reduced volatility, and that in turn may translate into better results, why would anyone hang on to a concentrated stock position? There may be many reasons, including legal restrictions on selling shares in an employer. But tax costs may be the biggest stumbling block. If you sell shares that have appreciated significantly since you bought them, you could find yourself paying today's 15% tax on long-term capital gains on almost the entire proceeds (unless you have large capital losses from this year or a prior year to offset your gains)—and that knocks a large hole in a new, diversified portfolio.

There are several alternatives to selling all at once. You might offset some risks of further concentrating your position by avoiding that holding's company and industry in the rest of your portfolio. You could divest your shares gradually in order to stretch out your tax liability. Very wealthy investors may be able to put a portion of concentrated holdings into an exchange fund, which avoids immediate taxes and gives investors shares in a diversified portfolio. Using some of the stock position to fund charitable goals could provide tax advantages and income, and company insiders might use a preprogrammed selling program known as a 10b5-1 to unload restricted shares.

All of those possibilities involve complex planning issues and need to be considered in view of your overall financial goals. For example, the current capital gains tax rate is the lowest it has been in many decades and may rise soon, and that could make it advantageous to incur those taxes now, not later. We can work with you to assess the vulnerability of a concentrated stock position and help you manage it wisely. ●

[1]The hypothetical stock portfolio in the Baird study had 12% of assets in large-cap growth, 14% in large-cap value, 8.5% and 3.5% in mid-cap and small-cap shares, respectively, 14% in international holdings, and 8% in a mix of "satellite" investments (emerging markets, high-yield bonds, commodities, and real estate).

contributions to Roth IRAs. Also, surviving spouses who complete a rollover to a Roth IRA may treat the Roth IRA as their own.

• If funds in a designated Roth 401(k) account are rolled over to a Roth IRA, the rollover isn't taxable, whether or not the transfer is a "qualified distribution."

• Other transfers, except for amounts representing after-tax contributions to your plan, are taxable.

• If you own company stock in a 401(k), you will not be taxed on the "net unrealized appreciation" (NUA) of the stock when it's distributed. But you can't avoid tax on the NUA by rolling over assets directly to a Roth.

• If you're married, you no longer need to file a joint return to benefit from the rollover provisions.

This is just an overview. We can work with you to weigh the merits of a Roth conversion and help you follow the rules governing such transfers. ●

The Right Way To Manage Money

In any relationship between financial advisor and client, trust is crucial. But in the post-Bernard Madoff era, it's not enough to sense that an advisor or a financial firm is reliable. Everyone trusted Madoff. His clients recommended him to their friends, who lined up for the privilege of having him manage their money. Yet all of those trusting clients ended up on the losing end of a $50 billion Ponzi scheme, and several other recent frauds have further shaken investor confidence. These days, trust requires proof, delivered regularly. Keeping your investments in the custody of a major financial firm can help provide that proof.

Madoff didn't use an outside custodian. Client funds were reportedly handled by a custodian at a remote storefront office that had few employees and no independent auditor. That left Madoff with unfettered access to clients' money and little or no accountability. It now appears he claimed to have made trades that never occurred and exaggerated returns from other transactions. But without reports or account statements from an independent custodian, there was no way for clients to know there was a problem.

Although Madoff's firm was a registered investment advisor, that kind of set-up is extremely unusual among RIAs, which are regulated by the Securities and Exchange Commission or the individual states. More than nine out of 10 RIAs serving individual clients work with independent custodial firms that have physical possession of client assets, monitor their value, and provide trade confirmations and account statements directly to clients, who can also check on investments by logging in to their account on the custodian's website.

Custodians, such as Fidelity, Schwab Institutional, TD Ameritrade Institutional, Pershing, and others, provide other kinds of security as well. Insurance from the Securities Investor Protection Corporation covers investors for up to $500,000 of losses of securities and $100,000 of losses of cash if a custodian becomes insolvent, and custodial firms often also purchase additional insurance. A common level of supplemental coverage is for up to $5 million of losses of securities. One company provides coverage for losses in securities accounts of up to $149.5 million and up to $900,000 in cash accounts. Moreover, most firms have automated systems to monitor client accounts.

To deter fraudulent activity, the SEC recently proposed a rule change that would require certain RIAs with custody of client assets to use an independent public accountant to conduct surprise audits of client accounts. But you don't have to wait for a new rule to protect your investments. We work with an independent firm that maintains custody of your assets, and you can easily compare the portfolio performance statements we provide with the custodian's account statements. This relationship is just one way we are working to prove that we deserve your trust. ●

Asset Protection Is Wise

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(JTWROS), they automatically pass to the survivor upon the other owner's death. A special type of co-ownership only between a husband and wife, known as "tenancy by the entirety" (TBE), may protect assets from creditors. More than half the states now recognize TBE protections.

In the nine community property states, on the other hand, property acquired during a marriage is generally treated as being owned by both spouses, regardless of how it is titled, and could be accessible to creditors of either spouse.

Domestic trusts. Various kinds of trusts created within the United States can help shield assets from creditors. For example, you could establish a "spendthrift trust" for a child. Normally, that involves transferring control of trust assets to a designated trustee, who will manage the trust. Creditors can't touch the assets before the beneficiary actually receives a distribution. The maximum protection is obtained with a discretionary trust which does not require distributions to be made at any particular time.

Self-settled trusts. A self-settled trust is one you form for your own benefit—you're the beneficiary as well as the grantor. Currently, 11 states allow you to establish self-settled trusts to protect assets from future creditors. To qualify, the trust must generally adhere to the laws of the state, have a trustee resident in such state, and be irrevocable.

Foreign trusts. A foreign or "offshore" trust can be a legitimate means for protecting assets by subjecting the property to the more lenient laws of a foreign jurisdiction. But foreign trusts also have disadvantages, including tax reporting requirements, lack of tax benefits, and concerns about trustees.

Devising an effective asset-protection plan is often complex and subject to crucial missteps. We can work with you and your attorney to create a plan that provides effective legal protections. ●