CIA Report

Financial Intelligence

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April 2014

Leveraging Your Assets

Leverage n. noun
1. The action of a lever.
2. The mechanical advantage of a lever.
3. Positional advantage; power to act effectively.
4. The use of credit or borrowed funds to improve one's speculative capacity and increase the rate of return from an investment, as in buying securities on margin.

When most individuals in financial services talk about leverage, they are referring to definition number four above. Countless stories have been told about millionaires who created a fortune by borrowing money to speculate into the right investments. Of course there are probably as many stories about those who leveraged their investments and lost their shirt.

Leverage is used by most Americans when they purchase a home. They increase their capacity to buy a house by putting up a down payment and borrowing the rest in the form of a mortgage. As we have seen by the mortgage bust of a few years ago, this can create huge nightmare scenarios but has allowed millions of Americans to afford homes they otherwise wouldn't have been able to buy.

At Capital Intelligence, when we think of leverage, we consider ways to make your money work harder and not necessarily taking more risk. With taxes due any day now a great example of leverage is setting up an IRA. For example, if you were to put aside $100 into a deductible IRA and were in a 30% tax bracket, the government would give you $30 back in taxes. You have $100 working for you but it only cost you $70.

Another example of leveraging the tax code is in charitable giving. When giving $100 to charity, assuming you meet certain requirements when you file your taxes, in the example above, the IRS will give you $30 back come April.

While these are simple examples, the concept of leverage can be used as you seek to create more income while you live, a greater inheritance for your heirs or to create other types of wealth besides financial wealth.

While we try to keep this cover article fairly simple in nature, the following page of this newsletter gives one example of using your charitable contribution not only to help an organization that you care about, but to also create an income stream for the rest of your life through what is called a Charitable Remainder Trust.

There are many other ways to use a charitable deduction to leverage wealth. An article in this Sunday's NY Times Sunday Review by Arthur C. Brooks pointed out that studies show that "donors ended up with more income after making their gifts". We know gifting can increase your net estate to your heirs.

There are clients who set up Foundations and/or Donor Advised Funds. They make their contribution and allow their children to help select beneficiaries. This provides an income tax deduction, but it also teaches the next generation about the importance of giving back values that most surveyed would rather pass on than money.

Many of our clients use Socially Responsible Investment principals to leverage the causes they feel are important to them, whether its religion, the environment, human rights, etc. By investing in companies they believe are doing the right thing or by divesting from companies that oppose their morals, SRI clients are not only trying to let their money grow, but to support (or avoid) causes they care deeply about. For those who think this has little effect, read a book on the divestment movement from South Africa in the 1980's.

Capital Intelligence is a small firm, but we leverage our ability by partnering with large organizations and outsources those things we can't do efficiently to who we think are the best providers available.

We hope you leverage our 70+ years of experience as you seek to reach your goals.

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Two Popular Charitable Trusts for You to Consider

Trusts with both charitable and noncharitable beneficiaries must follow special rules if you wish to receive income, gift, and estate tax charitable deductions for the amounts going to charity. Consult a tax or estate planning attorney familiar with charitable trusts.

A couple of charitable trusts are very popular with people making significant gifts to charity: the charitable lead annuity trust (CLAT) and the charitable remainder unitrust (CRUT). They each allow income, gift, and estate tax charitable deductions for a trust with both charitable and noncharitable beneficiaries. A CLAT leads off with a stream of annuity payments for the charity, while the CRUT provides a remainder interest for the charity when the trust ends.

Charitable lead annuity trust (CLAT)

With a charitable lead annuity trust, the charity generally receives the right to a fixed annuity amount each year (or at more frequent intervals). The annuity payments are generally made for a fixed term of years, or for one or more lives. After the specified term, the remaining trust property passes to you or another noncharitable beneficiary you designate.

An income tax charitable deduction is available to you at the time you create and fund the CLAT if the trust is structured so that you (as the grantor or creator of the trust) will be taxed on trust income each year. The up-front charitable deduction can be especially useful if you have a large amount of taxable income in the year the trust is created. If you take the up-front charitable deduction and cease to be taxed on trust income during the trust term (e.g., you die before the trust term ends), you may have to recapture part of the charitable deduction by adding the recaptured amount to your taxable income. For years in which you are not taxable on trust income, the trust may generally take charitable deductions against trust taxable income for distributions to charity.

The value of the up-front charitable deduction is based on the amount of the annuity going to the charity each year, how long the payments will be made to charity, and the appropriate interest rate used by the IRS to value the future payments.

A gift or estate tax charitable deduction is also available for the present value of the annuity interest the charity receives. Any remainder interest passing to a noncharitable beneficiary will be subject to gift or estate tax when the CLAT is created and will not qualify for the annual gift tax exclusion. The value of the remainder interest will be discounted to reflect that it will be received in the future. If the remainder interest passes to a person two or more generations younger than you, the generation-skipping transfer (GST) tax may apply.

Charitable remainder unitrust (CRUT)

With a charitable remainder unitrust, the noncharitable beneficiary receives a payment (the unitrust amount) from the trust property every year (or at more frequent intervals), which is based on the value of the trust assets each year. The unitrust payments are generally made for a fixed term of years, or for one or more lives. At the end of the trust term, the remaining property passes to the charity.

One CRUT variation permits payment of the lower of the unitrust amount or trust income for a period of years. Another CRUT variation then allows makeup distributions of the forgone unitrust payments at a later time. These variations may allow payments to be delayed until a later time, when the trust has income or the noncharitable beneficiary is in a lower income tax bracket.

An income tax, and gift or estate tax, charitable deduction is available to you at the time you fund the CRUT. The value of the up-front charitable deduction is based on the unitrust payout rate, how long the charity will have to wait to receive the remainder interest, and the appropriate interest rate used by the IRS to value the future interest. Any unitrust interest passing to a noncharitable beneficiary may be subject to gift or estate tax, as well as GST tax, when the CRUT is funded. The unitrust interest may qualify for the annual exclusion for purposes of the gift tax, but not for GST tax.

A CRUT is generally not subject to income tax. Instead, CRUT beneficiaries are taxable on unitrust payments as received. Distributions are treated as drawing out taxable income, capital gain, tax-exempt income, and trust corpus from the trust, in that order. In other words, distributions are generally treated as drawing out amounts taxable worst first. However, one advantage of a CRUT is that a CRUT can sell property and the beneficiary will not be taxed on capital gain from the sale until the beneficiary receives a distribution that is treated as capital gain.

Charitable deduction limits

The amount of your income tax charitable deductions are generally limited to 50% (or 30% or 20%) of your adjusted gross income (AGI), depending on the type of charity and the property transferred to the charity or charitable trust. Charitable deductions disallowed because of the percentage of AGI limits may be carried over and taken during the next five years, subject to the percentage of AGI limits in those years. Gift and estate tax charitable deductions are not subject to any percentage of AGI limit.

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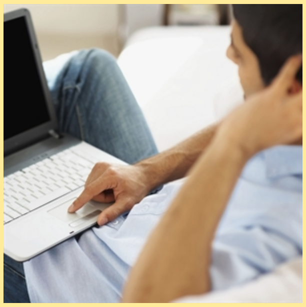
Test Your Knowledge of Financial Basics



A little knowledge can go a long way in pursuing your financial goals. For more information about the topics in this article, or for other personal finance-related questions, speak with a trusted financial professional.

All investing involves risk, including the possible loss of principal.

Working with a trusted financial professional is one of the best ways to help improve your overall financial situation, but it's not the only thing you can do. Educating yourself about personal finance concepts can help you better understand your advisor's recommendations, and result in more productive and potentially more prosperous financial planning discussions. Take this brief quiz to see how well you understand a few of the basics.

Questions

1. How much should you set aside in liquid, low-risk savings in case of emergencies?

a. One to three months' worth of expenses

b. Three to six months' worth of expenses

c. Six to twelve months' worth of expenses

d. It depends

2. Diversification can eliminate risk from your portfolio.

a. True

b. False

3. Which of the following is a key benefit of a 401(k) plan?

a. You can withdraw money at any time for needs such as the purchase of a new car.

b. The plan allows you to avoid paying taxes on a portion of your compensation.

c. You may be eligible for an employer match, which is like earning a guaranteed return on your investment dollars.

d. None of the above

4. All of the money you have in a bank account is protected and guaranteed.

a. True

b. False

5. Which of the following is typically the best way to pursue your long-term goals?

a. Investing as conservatively as possible to minimize the chance of loss

b. Investing equal amounts in stocks, bonds, and cash investments

c. Investing 100% of your money in stocks

d. Not enough information to decide

Answers

1. d. Conventional wisdom often recommends setting aside three to six months' worth of living expenses in a liquid savings vehicle, such as a bank savings account or money market mutual fund. However, the answer really depends on your own individual situation. If your (and your spouse's) job is fairly secure and you have other assets, you may need as little as three months' worth of expenses in emergency savings. On the other hand, if you're a business owner in a volatile industry, you may need as much as a year's worth or more to carry you through uncertain periods.

2. b. Diversification is a smart investment strategy that helps you manage risk by spreading your investment dollars among different types of securities and asset classes, but it cannot eliminate risk entirely. You still run the risk of losing money.

3. c. Many employer-sponsored 401(k) plans offer a matching program, which is like earning a guaranteed return on your investment dollars. If your plan offers a match, you should try to contribute at least enough to take full advantage of it. (Note that some matching programs impose a vesting schedule, which means you will earn the right to the matching contributions over a period of time.)

Because 401(k) plans are designed to help you save for retirement, the federal government imposes rules about withdrawals for other purposes, including the possibility of paying a penalty tax for nonqualified withdrawals. You may be able to borrow money from your 401(k) if your plan allows, but this is generally recommended as a last resort in a financial emergency. Finally, traditional 401(k) plans do not help you avoid paying taxes on your income entirely, but they can help you defer taxes on your contribution dollars and investment earnings until retirement, when you might be in a lower tax bracket. With Roth 401(k)s, you pay taxes on your contribution dollars before investing, but qualified withdrawals will be free from federal, and in many cases, state taxes.

4. b. Deposits in banks covered by the Federal Deposit Insurance Corporation are protected up to $250,000 per depositor, per bank. This means that if a bank should fail, the federal government will protect depositors against losses in their accounts up to that limit. The FDIC does not protect against losses in stocks, bonds, mutual funds, life insurance policies, annuities, or municipal securities, even if those vehicles were purchased at an insured bank. It also does not protect items held in safe-deposit boxes or investments in Treasury bills.

5. d. To adequately pursue your long-term goals, it's best to speak with a financial professional before choosing a strategy. He or she will take into consideration your goals, your risk tolerance, and your time horizon, among other factors, to put together a well-diversified strategy that's appropriate for your needs.

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This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

I KNOW RETIREMENT PLANNING IS A JOURNEY BUT SOMEHOW I THOUGHT THERE'D BE BETTER TRAIL MARKINGS.