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FINANCIAL ASSOCIATES

Second Quarter 2011

Guide...Protect...Preserve

The Twenty Top Tax Breaks In The New 2010 Tax Act

The 2010 Tax Relief Act includes dozens of tax breaks for individuals and businesses. Here are 20 of the top provisions.

1. No increase in income tax rates. Rates in the top two income brackets had been scheduled to rise from 35% to 39% and from 33% to 36%. The new law also preserves relief from the "marriage penalty" for joint filers.

2. Status quo for capital gains and dividends. The maximum tax rate for long-term capital gains was supposed to jump to 20% (10% for low-income individuals), and dividends would have been taxed as ordinary income. Now, the existing 15% rate for long-term gains and dividends remains for most taxpayers through 2012.

3. Lower payroll taxes. For 2011 only, the law authorizes a two percentage point drop—to 4.2%—in employees' share of the Social Security tax, due on the first $106,800 of wages. You get the same break if you're self-employed.

4. Alternative minimum tax (AMT) relief. The new law slightly increases the exempt amounts on 2010 and 2011 returns for avoiding exposure to the AMT and its bigger tax bite. The amounts had been scheduled to revert to low, pre-2001 levels.

5. No phaseouts for itemized deductions and personal exemptions. Before 2010, itemized deductions and personal exemptions were phased out for high-income taxpayers. But those limits were repealed for 2010, and the new tax act extends that relief through 2012.

6. A bigger break for owning qualified small business stock (QSBS). The maximum 50% exclusion for investments in QSBS had been temporarily increased to 75%. Now, under the new tax act, there's a 100% exclusion for QSBS acquired before January 1, 2012.

7. An enhanced education credit. The American Opportunity Tax Credit (AOTC), which expanded the Hope credit for college expenses, was scheduled to expire after 2010. Now, the maximum $2,500 AOTC is extended through 2012, though it's still phased out for high-income taxpayers.

8. A bigger deduction for college savings. The maximum $2,000 deduction for contributions to Coverdell Education Savings Accounts, slated to drop to $500 after 2010, is extended through 2012.

9. A partial reprieve for Section 179 deductions. The maximum Section 179 deduction, which rose from $250,000 to $500,000 for qualified business property placed in service in 2010 and 2011, was then scheduled to drop to $25,000. The new law allows a maximum $125,000 deduction for 2012.

10. A bonus for bonus depreciation. The tax act retroactively reinstates this business perk, which had expired after 2009. A 100% bonus depreciation deduction is generally available for qualified property placed in service in 2011, and there's a 50% deduction for 2012.

11. Revived credit for going green. The credit for home energy-saving devices, scheduled to expire after 2010, is

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SEC Regulates Our Firm And It's Staying That Way

As part of the massive Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, regulation of about 4,200 Registered Investment Advisors (RIAs) is being switched from the Securities and Exchange Commission (SEC) to state authorities. The change-over, which applies to RIAs with assets under management (AUM) of less than $100 million, will be complete on July 21, 2011.

Initially, the SEC shared responsibility for all RIAs with the states, although the SEC usually dominated high-profile enforcement cases. A 1996 law shifted oversight to the states for RIAs with AUM under $25 million. The new law pushes the threshold to $100 million.

Because our firm exceeds the new state maximum, we'll still be monitored by the federal agency. There are several benefits to this continuity.

- The SEC, which has been policing RIAs for more than 70 years, has well-trained investigators with the experience needed for this job.
- States face daunting challenges in meeting the torrent of additional registrants. In comparison, the SEC's load will be lightened (though it has also been assigned certain additional duties).
- The SEC is well funded, while many states are currently strapped for cash.

Though you're ultimately responsible for your own financial future, you depend on guidance from trusted advisors, and our continued regulation by the SEC only serves to underline our total commitment to our clients.

Mary Jane Callaghan &
Mitch Glicksman

401(k) Alternatives For Business Owners

If you have fewer than 25 employees in your small business, a 401(k) plan may not be right for you. But if your business offers no retirement plan at all, you could lose out in attracting the most qualified job candidates. One or more of these alternatives might be a better fit for your situation.

Simplified Employee Pension (SEP IRA). A SEP IRA is low cost and low maintenance.

- The employer makes all of the contributions; employees can't add to their accounts.
- The plan must cover all eligible employees.
- There is no "plan document."
- You don't have to file annual reports with the IRS.
- Contributions are tax deductible.
- Contributions can vary from year to year. So if you hit a lean spell, you aren't locked in.

Savings Incentive Match Plan for Employees (SIMPLE IRA). For a business with fewer than 10 employees, the SIMPLE IRA is a great starter plan.

- Your contribution is required; employees have the option of contributing.
- But you can't sock away as much for yourself as you can with a SEP IRA, which for 2010 allows a maximum contribution of $49,000. SIMPLE IRA contributions are normally capped at $11,500 ($14,000 for those 50 or older at year's end) plus an employer matching contribution that can't exceed 3% of salary.
- Don't confuse the SIMPLE IRA with the SIMPLE 401(k), which is like a traditional 401(k) plan but with higher fees and less flexibility.

Profit-Sharing Plan. This gives each employee a slice of the company's earnings.

- An overall annual contribution, based on the company's performance, is apportioned to individual accounts according to each employee's salary.
- Contributions are discretionary and tend to vary from year to year.
- A business of any size may use a profit sharing plan and can combine it with other retirement plans.
- Businesses with profit-sharing plans must file IRS Form 5500 each year.
- Administrative costs may be higher than under more basic plans, because this plan must perform a non-discrimination test to ensure it doesn't favor highly compensated employees.

Defined-Benefit Plan. This is the most costly, complex plan for small businesses, but it has one big potential advantage—it lets you make very large contributions that can quickly build your nest egg. You're now allowed to fund a maximum annual retirement benefit of $195,000.

- Your contributions are mandatory.
- You can't decrease benefits retroactively.
- Defined-benefit plans are available to businesses of any size and can be combined with other retirement plans.
- Requires filing an IRS Form 5500 with a Schedule B each year.

The Schedule B must be signed by an enrolled actuary, who will calculate contribution amounts based on your employees' ages and the target benefit. ●

Grantor Annuity Trusts Remain Viable

Recently proposed legislation would have severely reduced the tax benefits of the grantor retained annuity trust (GRAT). However, this popular estate planning technique has dodged the cutting block, at least for the time being. As a result, now is a good time to review your options.

GRATs, which are irrevocable trusts, are typically funded with income-producing property such as company stock or real estate. The trust pays you annual income for a set period of time that may be only a few years. When the term expires, the assets that remain in the trust go to beneficiaries you have designated—perhaps your children or grandchildren.

The IRS treats the transfer of those remaining assets as a potentially taxable gift—but it determines the value of that gift when the trust is set up, not when its term expires. To calculate the remainder, you take into account two factors: how much the trust assets would increase if they grew at a specified IRS interest rate; and how much they will be reduced by the annuity payments to you. For this calculation, you use the "Section 7520" rate in effect when the trust is established. (The rate is adjusted up or down each month to reflect prevailing interest rate conditions.)

With current rates quite low—the Section 7520 rate in April 2011 was 3.0%, compared with 6.2% as recently as August 2007—this can be a good time to transfer property to a GRAT. If the actual appreciation of the trust assets exceeds the specified rate, you and your beneficiaries come out ahead, because that additional amount won't be taxed.

Suppose you transfer $1 million in company stock to a GRAT with a three-year term. You can structure the trust so that the payouts to you exactly equal the hypothetical value of the assets if they grow at the Section 7520 rate.

Diversification And Social Cause Investing

In the old days of socially responsible investing (SRI), following your conscience tended to come at the cost of at least a few percentage points in lost returns. SRI funds were few in number, and they tended to focus on avoiding broad swaths of the investing universe. Staying away from companies that slaughtered animals for food or provided feed for slaughterhouses, for example, would mean not investing in many large multinational firms—and in the large-cap mutual funds that hold those companies. Or objections to Asian labor practices would rule out putting money in many promising international stock funds that invested in that region. If you wanted to have a broadly diversified portfolio, you could pretty much forget about SRI.

Recently, though, several changes in socially responsible investing are making it much easier to diversify. Many SRI funds have shifted their emphasis from passively avoiding objectionable investments to an approach that actively seeks investment in profit-driving fundamentals—and that leads the funds to previously unexplored corners of the corporate world. Rather than simply shunning companies that profit from tobacco, polluting industries, child labor, or other frowned-upon products or behaviors, today's SRI funds invest in companies that embrace socially positive behaviors that may also boost the bottom line. Many SRI investment managers look for companies that focus on environmental sustainability and responsible governance, which they believe will foster success and reward investors.

This trend has led to a new acronym, "ESG," for "environmental, social, and governance." Today's SRI investors believe companies that focus on these three characteristics will perform better in the long term, partly by reducing their potential liability amid rising tensions in these areas.

Another factor in SRI's evolution is a rapid growth in the number of SRI funds. Increasing concerns about the environment and moral issues ranging from abortion to gun violence are prompting more fund managers to offer SRI-focused choices that may specialize in a particular area. Having more mutual funds and exchange-traded funds built around SRI principles makes it easier to tailor investments to your concerns and helps you to diversify. And whereas in the past most SRI funds concentrated on large-cap stocks—and usually considered only a narrow range of those big companies—now investors can also choose from among small-cap and mid-cap SRI funds.

One widely cited study, the Social Investment Forum's 2007 Report on Socially Responsible Investing Trends, showed that between 2005 and 2007, the amount of money committed to SRI funds rose at an 18% annual rate. More than 10% of all investment dollars under professional management in the United States, or \$2.7 trillion, was invested in SRI funds in 2007, the report said, and more than 260 socially screened mutual funds were available in the United States, up from just 55 in 1995. A number of recent studies have shown that funds screened for social concerns have performed comparably to non-SRI funds in terms of average annual growth.

If you are interested in SRI, or ESG, what do you need to know? Here are some questions, courtesy of Morningstar:

- **What issues are most important to me?**
  Are you interested in a religious or a secular fund? What issues are driving your decision—the environment, workplace diversity, weapons proliferation?
- **How does a fund screen its investments?**
  Do the fund managers screen out all involvement in your issue, or do they take the approach of investing only in those firms with "best practices" in the industry involved in your issue?
- **Is this fund involved in shareholder activism and community investment?**
  Look at the fund's website or call the fund company to find out whether managers actively push for change among companies they invest in, and determine whether this matters to you.
- **Is this a good investment?**
  You must do your homework as you would with any fund, and also be aware that many SRI funds charge higher fees to pay the cost of added research.
- **How do these funds work within my overall portfolio?**
  Any fund you invest in should be seen as part of a rational investing strategy that is properly diversified, including SRI funds.

We can help you consider these and other questions related to social responsible investing and work with you to create a portfolio that addresses your priorities, financial and otherwise. ●

Diversification does not guarantee investment returns and does not eliminate the risk of loss. Mutual funds are offered by prospectus. Please consider the charges, risks, expenses, and investment objectives carefully before investing. The prospectus contains this and other information and may be obtained from our office or from the fund company directly.

Such a GRAT is said to be "zeroed out"—because the remainder, and thus your tax liability, is projected to be zero.

If you die before the trust expires, the property remaining in the trust reverts to your taxable estate. That defeats one purpose of establishing a GRAT—to reduce the value of your estate—and the shorter the term of the GRAT, the better the likelihood that you'll outlive it. But under the bill that passed the House of Representatives, a GRAT would be required to last at least 10 years, and you would no longer be allowed to zero out the trust.

Currently, the GRAT remains a valuable estate planning tool for some families. But proposals restricting the benefits are sure to surface in Congress again. We can work with you and your attorney to determine the right move in your situation. ●

It's NOT The Economy, Stupid!

In 1992, then-candidate Bill Clinton used the slogan "It's the economy, stupid" to help him stay on message and pound President George H.W. Bush for his failure to pull the country out of a recession. The point was that jobs and other economic issues were what mattered most to voters. Yet while that may still be true as far as elections go, it oversimplifies things when it comes to investments. Your results ultimately have more to do with the choices you make in responding to economic conditions, rather than the actual state of the economy itself.

This is an important distinction that underscores the limits of a pure "buy and hold" strategy that just sticks with investments to wait for them to match their average past performance. While stocks do tend to track the general economy over very long periods of time—and stocks, like the economy, have always ultimately prospered—few investors can afford to wait several decades for beaten down investments to bounce back. Instead, it makes sense to take steps to mitigate the risk of sharp losses.

The events of the past few years have forcibly illustrated the fact that equities can be extremely volatile in the short term. And even if you're still 20 or 30 years from retirement, market ups and downs have a real impact on your returns. It's only at the 40-year mark that returns tend to fall in line dependably with economic progress, according to a recent study by economist Richard W. Kopcke and researcher Dan Muldoon at the Center for Retirement Research at Boston College.

Their study—"Why Are Stocks So Risky?"—shows that investor behavior has a far stronger influence over returns than do the gyrations of the economy, especially over periods of 20 years or less. The authors define investor behavior as "the way shareholders react to their uncertainty about economic conditions, form opinions about the future, and manage their portfolios."

The good news is that of the two factors—economic conditions and investor behavior—that influence investment returns, the one that exerts the greater influence is the one you control. What really matters are the decisions you make in setting up and operating your investment portfolio.

Those choices include everything from defining your risk tolerance and setting life goals to diversifying your portfolio and reallocating assets in response to shifting short- and long-term trends. Maintaining broad diversification spreads your risk across and within multiple asset classes, and making regular, strategic reallocations helps you stay diversified even as conditions change.

Now, as the economy embarks on what could be a long, uncertain recovery, we can help you make sure that your portfolio is positioned to reflect who you are and what you want to accomplish.

Diversification does not guarantee investment returns and does not eliminate the risk of loss

Top Tax Breaks

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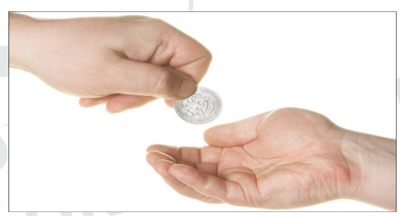
extended through 2011, but the credit is limited to 10% of the cost of improvements (it had been 30%) and a maximum of $500.

12. Offspring benefit. The child tax credit of $1,000 per child was going to lapse after 2010; now it will be in force through 2012.

13. Help with adoption costs. The new law extends the credit for adoption expenses—now a maximum of $12,170, down from $13,170 in 2010—through 2012.

14. Money for hiring. The Work Opportunity Tax Credit, available to businesses for employing workers from "target" groups, now won't expire as planned on August 31, 2011, but will stay in force through 2012.

15. Reward for taking the bus. The maximum monthly $230 tax-free benefit for transit passes, scheduled to decrease to $120 after 2010, is extended through 2011.



16. A renewed deduction for corporate largesse. Enhanced deductions for companies' contributions of food inventory, books and computer equipment, which expired after 2009, are retroactively extended through 2011.

17. Option to deduct sales tax. The chance to write off sales tax, rather than state and local income taxes, ended after 2009 but now is back for 2010 and 2011.

18. Deduction for IRA transfers to charity. The ability to direct an annual maximum of required IRA distributions to charitable organizations, which had expired after 2009, is retroactively extended through 2011.

19. Generous estate tax rules. Following the temporary repeal of the tax for 2010, it's reinstated but with a $5 million exemption and a top tax rate of only 35% and the reunification of estate and gift taxes through 2012. And heirs will again benefit from a step-up in basis on inherited assets.

20. A break on generation-skipping tax (GST). The new law coordinates the GST with the estate tax rules through 2012, with the same maximum exemption of $5 million. ●

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