



# FINANCIAL *Planning Strategies*

A Financial Planning Update

**WestPoint** *Private client*  
G R O U P



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## Investing in a Global Marketplace

If you're looking to **diversify** your investments against fluctuations in the American economy, then you may want to consider investing in foreign securities. This strategy assumes that by investing in more than one economy, individuals can "level out" the expected fluctuations that inevitably occur both domestically and abroad. The ever-expanding global marketplace has made the purchase of foreign investments much easier for today's individual investor.

### Assessing the Risks

When most people think of purchasing domestic securities, they typically consider any potential risk at least to be familiar, while "foreign" issues often suggest something unfamiliar and, therefore, inherently more risky. However, splitting an equity portfolio between domestic and foreign securities may be a smart way for investors to help reduce risk. One country's economy may be *expanding* while another's is

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## Playing the Field with Variable Annuities

One of the keys to successful money management is a *well-diversified* investment portfolio consistent with your overall financial goals and your level of risk tolerance. That's why it is important to keep an open mind when you review the different types of financial products available in today's marketplace.

With this in mind, how much attention have you recently given to **variable annuities**? If you have never considered a variable annuity, you may be missing out on what some investors consider a value-added addition to their long-term savings and investing plan.

### What Makes Them So Special?

Variable annuities are insurance contracts that provide individuals with the following benefits: 1) professional money management; 2) *tax-deferred* earnings without limits on contributions; and 3) a guaranteed income and death benefit subject to the issuer's claims-paying ability.

A variable annuity differs from a *fixed* annuity in that it doesn't guarantee an interest yield from investments. Its value is based on the performance results of one or more underlying sub-accounts that invest in stocks, bonds, or money market instruments. It is the

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## The “Kiddie Tax” Grows Up Fast

The \$70 billion tax bill signed into law on May 17, 2006, the Tax Increase Prevention and Reconciliation Act (TIPRA), delivered a tax increase to families with investment income. This reform expanded the “kiddie tax” by raising the age limit from 14 to 18. Up until age 18, investment income for children exceeding \$1,700 will be taxed at the parents’ generally higher rates. Any gains realized in 2006 will be subject to the new rules, as will all gains in subsequent years.

For many families, this sudden change affects their tax-efficient investing strategies, particularly those developed to help fund a college education. While the reform does not affect the taxation of 529 plans or Coverdell Education Savings Accounts (ESAs), it does affect custodial accounts and investment holdings that generate taxable income.

### The Tax Impact

The kiddie tax kicks in when investment income exceeds \$1,700 for children under age 18. They do not pay tax on the first \$850 of investment income, and they pay tax at their own rate on the next \$850. Any unearned income above \$1,700 is taxed at the parents’ rate. For long-term capital gains, the top rate is 15%, while the top marginal income tax rate is 35%. A special rule exempts teens who are under 18 but are married and filing a joint return. Bear in mind that the kiddie tax only

applies to a child’s unearned income; wages from employment are exempt.

For illustrative purposes, let’s suppose your 16-year-old daughter has \$5,000 of interest income. Under current rules, she pays no tax on the first \$850 and then 10% on the next \$850. The remaining \$3,300 is taxed at your rate, and let’s assume it’s 35%. The tax on her income would total \$1,240. Under the old rules, her tax would have been \$415.



In order to take advantage of their children’s lower tax brackets, many parents shifted appreciated stock to their kids. The children would then sell the assets, oftentimes to pay for college expenses, and pay tax at their own, likely lower, rates. In 2007, taxpayers with income less than \$31,850 pay only 5% on long-term capital gains and qualified dividends. From 2008 through 2010, taxpayers in the bottom tax brackets pay zero tax on long-term gains and dividends.

With the kiddie tax’s new bump up in age, these

asset-shifting plans now have different tax consequences. Rather than owing 5% tax on long-term gains for their college-bound kids, unsuspecting families may now owe 15%. Furthermore, any plans to take advantage of the zero-tax window will have to be revised.

### Alternate Strategies

If changes in the kiddie tax negatively impact your education strategies, consider your other tax-favored options, such as 529 plans and ESAs. 529 college savings plans are state-sponsored investment accounts that offer tax-deferred earnings and tax-free withdrawals for qualified higher education expenses. Eliminating some of the uncertainty surrounding these plans, Congress made permanent the favorable tax benefits for 529 plans that were set to expire in 2010.

ESAs also offer tax-deferred earnings and tax-free withdrawals, and funds may be used to fund secondary-school expenses, as well as college expenses. Annual contributions are limited to \$2,000, and income limits apply.

To keep a child’s investment income low, consider growth stocks that pay little in dividends. The tax liability occurs if and when the stocks are sold for a gain. Also consider tax-efficient and low-turnover mutual funds. Buying and holding an investment until a child reaches age 18 can

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## Investing in a Global Marketplace

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contracting, which can mean that when prices are declining at home, they may be rising elsewhere. Of course, investments in foreign securities can involve additional political and economic risks, particularly with respect to currency fluctuations.

Ironically, one of the factors that can contribute to foreign currency fluctuation is direct and indirect investment from outside the country. When investors see an economic opportunity and purchase securities, it can create a demand for the local currency that, in turn, can affect its value. Investors who rely on bond income for their living expenses may find this type of potential volatility unnerving.

### Understanding the Benefits

Buying securities abroad currently has the potential to help protect against inflation at home. When inflation runs high in the United States, interest rates tend to rise, depressing issued bond and stock prices. During a period of high domestic inflation, the value of the

dollar may decline because it would take more dollars to buy the same goods and services. The value of currencies of low inflation countries may increase in relation to the dollar because those currencies can be **converted** into a greater number of dollars. The reverse also holds true: When inflation runs high overseas, foreign stocks and bonds may convert into fewer dollars. As a result, U.S.-issued bonds and stocks may look more attractive.

**Mutual funds** are generally considered to be the most reasonable way for the casual or average individual investor to gain foreign exposure. **Global bond funds** invest in developed nations, but generally have more than 25% of their assets in domestic issues; **international bond funds** invest in developed countries, but U.S. bonds may make up a quarter of their holdings; **emerging-market funds** invest in developing countries and, as a result, may have greater volatility (as well as greater returns). There are also mutual funds that target select countries

and specific regions of the world. Investors with only limited foreign equity exposure in their portfolios may want to consider sticking with global funds, since they can more easily shift funds to U.S. markets when foreign markets appear unattractive.

Whether looking homeward or abroad, investors should always remember that past performance is not a guarantee of future results; investment values will fluctuate in response to market conditions. As a result, when shares of particular investments are redeemed, they may be worth more or less than their original cost. A thorough review of each fund's prospectus will provide you with greater insight into the fund's objectives, risks, and assets under management—whether they're in the U.S. or abroad. \$

*Note: International securities have additional risks, such as currency exchange fluctuations, different accounting standards, governmental regulations, and economic conditions not present with domestic investments.*

## The “Kiddie Tax” Grows Up Fast

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help you mitigate the implications of the new rules.

### Financial Aid Considerations

When it comes to financial aid, there are definitely advantages to

keeping money earmarked for education out of your child's name. Colleges generally expect 35% of a student's assets to be dedicated to education, whereas the expectation for parents is lower—only 6% of your assets are considered in the

funding formula for aid. The less savings children have in their own name, the more aid they may receive, depending on the cost of attendance and your family's overall financial situation. \$



## Playing the Field with Variable Annuities

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variety of investing options that may make variable annuities attractive to individuals at many stages of life. You can select investments consistent with your financial goals and your risk tolerance.

### Accumulation and Payout

Variable annuities have two key phases: accumulation and payout. During the accumulation phase, you invest your annuity payments in your choice of investment options, generally a mix of stock funds, bond funds, and a fixed-interest option. Your earnings depend on the performance of your chosen investments.

Money paid into a variable annuity has the potential to accumulate on a tax-deferred basis, which means you pay no current income tax on earnings. In addition, you can generally transfer money from one investment option to another without incurring a tax liability; however, the issuing insurance company may charge fees.

During the payout phase, you receive income from your annuity based on the amount you paid in as well as the performance of your investments. You may receive a lump-sum payment or choose to

receive regular payments over a specified period of time. Most annuities offer a number of different payout choices, such as payments for your lifetime, for the lives of you and your spouse, or for a certain number of years (usually 5, 10, 15, or 20 years).

Earnings from a variable annuity are taxed as ordinary income, rather than as long-term capital gains. Withdrawals made before the age of 59½ may be subject to a 10% federal income tax penalty. In addition, surrender charges may apply if you access funds within a certain time frame (generally six to eight years) after purchasing the contract.

### Death Benefits

While variable annuities charge insurance-related fees, they also provide a measure of insurance protection, such as the opportunity to receive income for life. Moreover, variable annuities also offer death benefits. If you own a variable annuity and die before receiving payouts, your chosen beneficiary will receive either the assets in your account or a guaranteed minimum, whichever amounts to more.

Depending on your contract, you may be eligible to purchase a "stepped-up"

death benefit, which secures investment gains on a set schedule and guarantees a death benefit equal to the stepped-up amount. This feature can help protect against market downturns, and there is generally an extra annual fee.

### A Good Fit?

Variable annuities can provide investors with valuable benefits, including professional management, the advantage of tax deferral without limits on contributions, and death benefits. They are a valuable investment option for long-term investors looking to generate retirement income. The bottom line: Early planning *today* can help you plan for tomorrow. \$

*In addition to sales and surrender charges, variable annuities may impose a variety of fees, including mortality and expense risk charges, administrative fees, underlying fund expenses, and charges for special features, such as stepped-up death benefits. The principal value and rate of return in a variable annuity will fluctuate due to market conditions. Therefore, at any point in time, the value of the annuity contract may be worth more or less than the owner's actual investment in the contract. Guarantees are based on the claims-paying ability of the issuing company.*

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