

SA-KG ADVISORS QUARTERLY



Does Your 529 College Savings Plan Match Up?

When the Pension Protection Act of 2006 made 529 college savings plans a permanent part of the tax code, it ended most debate about the best way to invest for educational expenses. However, there are dozens of state-sponsored plans to consider, each varying in everything from investment choices and performance to plan costs and tax advantages. Understanding the differences can help you find a plan that makes the most of your college savings.



- All 529 plans offer these benefits:
- No income requirements and very high caps on account contributions
 - No federal income tax on investment earnings, nor on distributions to pay qualified college costs
 - Plan owners retain control of how assets are used. If a plan owner's child doesn't go to college, he can name another family member as beneficiary or even take back contributions, though normally with a 10% penalty and tax on investment profits. (One strategy lets you avoid taxes and penalties by making a charitable donation of an unused plan.)
 - Your ownership of plan assets means favorable treatment in federal financial aid formulas, increasing your child's chance of qualifying for federal aid (though it may lower aid packages from institutions).
 - You can lump together five years' annual gift-tax exclusions to make a single 529 contribution. Because you

and your spouse may each give up to \$13,000 a year without gift-tax liability, you can jump-start a plan with up to \$130,000 while also removing that money from your estate if you live for five more years.

Get past the basics, and differences among plans emerge. A distinguishing feature is whether the plan is sold directly to investors or through a financial advisor. Savingforcollege.com and Morningstar.com provide databases of 529 plans and guidance on plan selection. Savingforcollege rates effectiveness on a one- to five-cap scale, and each year Morningstar names the country's five best and worst plans. In both cases, evaluations are based on several criteria:

Costs. Some plans dun you for enrollment, account maintenance, and program management charges, while others charge only for your underlying investment expenses, which may range from a few basis points annually to nearly 2%. Each basis point equals 1/100th of a percent. Comparing 10-year costs on a \$10,000 investment, Savingforcollege found overall expenses ranging from \$0 (for investing in one state's fixed-earning plan) to \$2,616. Since fees are a steady drain on investment performance, it makes sense to choose a low-cost plan.

Investment options. Whereas some plans offer just one or two kinds

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Don't Make The Economy's Crisis Your Crisis

As the economic crisis widens, more people are taking early withdrawals from retirement plans. While that may solve immediate problems, draining money from retirement accounts only guarantees you'll feel the effects of these hard times long after they've passed.

According to an AARP survey, 13% of Americans age 45 and older took cash out from 401(k)s or other retirement plans between September 2007 and September 2008 to pay everyday expenses. That's regrettable, for several reasons. It depletes an account that's meant to support you after you stop working, and spending the money now means missing years of potential investment gains. In addition, if you haven't passed age 59½, you'll not only be taxed on the withdrawal but also owe a 10% penalty (unless you meet a few special circumstances). Take, say, a \$10,000 distribution, and if you're in the 28% tax bracket, you'll pay \$2,800 in federal income tax plus a \$1,000 early withdrawal penalty. That leaves you just \$6,200—before you pay state taxes.

A better option, if you must tap retirement accounts at all, is to borrow from your 401(k) or make a temporary withdrawal from an IRA that you pay back within 60 days. But touching this money should be only a very last resort. Instead, evaluate your spending habits and give up any non necessities. The economy and the markets will inevitably recover, and so will your retirement plan—but only if you haven't raided it in the meantime.

Creating A Comfortable Financial Independence Plan

Everyone needs a financial blueprint for life after work. Operating without one is a little like closing your eyes as you barrel down the freeway. It's essential to know where you're going and how you expect to get there. But a financial independence plan will help you achieve your goals only if you incorporate it into your financial life, and that won't happen unless the plan feels comfortable. And that comes from understanding its component parts and how they're connected. Consider these elements:

Cash flow analysis. Your plan needs to project where your money will come from and where it will go during the rest of your life (and your spouse's life, too, if you're married). What will come in during retirement, from Social Security, a company pension, annuities, and from drawing down your savings? And how will that match the needs of the lifestyle you want? Several unpredictable variables complicate these calculations. Inflation affects how far your money goes, and investment returns, based in turn on economic and market cycles and your choices, determine how much you have to spend. Taxes will also play a role.

Investment choices. Three factors affect what should be in your investment portfolio. Your goals: What kind of return do you need, both while you're working and during retirement, to support your lifestyle? Your risk tolerance: How much volatility in portfolio returns are you willing to accept to meet your goals? Taking greater risks may provide higher potential long-term returns, but not if you panic and sell when the market takes a turn for the worse. And your time horizon: How long do you have to save for retirement, what is your tax bracket, and how many years do you need your savings to last?

Contingency plans. Job losses, expensive illnesses, or the unexpected death of you or your spouse could put your plan off track. There could also be unforeseen expenses involving your children or parents, and the need for nursing home care during retirement could quickly drain your savings.

Having a cash cushion along with life, disability, and long-term care insurance can prepare you to handle potential setbacks. Not planning for lifestyle changes is a major mistake and will put your financial future in jeopardy.

Estate planning. This is crucial even if estate taxes aren't likely to be an issue. You need a will, periodically updated, and a letter of instruction that tells heirs where to find information about financial accounts, life insurance, safe deposit boxes,

and the like. It's also important to designate beneficiaries for 401(k)s, IRAs, and other financial accounts that reflect your wishes and take into account potential tax liability.

It can be complicated to weave together all of these elements. But we have the tools, expertise, and experience to help you create a financial plan that feels comfortable. ●



Lessons From The Wall Street Giants' Fall

The March 2008 downfall of Bear Stearns Cos. was only the first of several failures of erstwhile Wall Street titans. Less than six months after the investment bank had to sell itself to JPMorgan Chase & Co. for next to nothing, Merrill Lynch & Co. was acquired by Bank of America Corp., and Lehman Brothers Holdings Inc. declared bankruptcy. What brought down these and other high-profile institutions was excessive risk and a lack of diversification—the same fatal flaws that doomed the retirement portfolios of

employees at Bear Stearns and many other companies. For the Wall Street banks, the problem was massive bets on mortgage-backed securities. For the workers, it was holding too much stock in their own companies.

We've been down this road before. The 2001 collapse of Enron Corp. decimated its employees' retirement portfolios, and that outcome has repeated itself at many a corporate victim of irrational exuberance. Enron's fall cost 5,600 people their jobs, and many had most or all of their retirement money riding on Enron

stock, which became worthless when the energy company declared bankruptcy in December 2001.

(In a settlement reached in September 2008, five banks that worked with Enron agreed to pay a record \$7.2 billion to some investors, who will get an average of \$6.79 per share of common stock. At Enron's peak, shares had sold for more than \$90.)

When Bear Stearns was sold, the investment bank's 14,000 employees owned one third of the firm's stock, which had plummeted by 80% in preceding

Low Rates Give Estate Planning A Boost

Several techniques to cut gift- and estate-tax liability depend on interest rates published by the IRS, and those rates, like others, recently neared record lows. Despite an inflation rate that many believe will creep up and an extremely volatile stock market, hitching your estate plan to one or more of these vehicles or revisiting plans created when rates were higher could deliver major benefits.

Loan to family. Each month, the IRS publishes short-, mid-, and long-term Applicable Federal Rates (AFRs). When you make a loan, you need to charge interest at least as high as the AFR that applies to the loan term. (If you accept less, the loan may be considered a gift.) Suppose you lend your daughter a sum of cash for nine years at a mid-term AFR of 3%. If your daughter invests the borrowed money in a portfolio returning 7%, that four percentage point difference means she'll come out ahead, earning more than she must repay. But that gain will be in her estate, not yours, and the loan reduces the size of your estate, cutting potential estate taxes. Of course, if her return is less than the 3% "hurdle rate," this becomes a losing strategy.

Sale to an intentionally defective grantor trust. This accomplishes many of the same goals as a loan to family members and it benefits from low

interest rates in the same way. In addition, because you, rather than the trust, pay income tax on earnings from the trust assets, your estate is further reduced, while the trust assets grow unencumbered by taxes. If you sold property to a defective trust some time ago and received a note, you may be able to refinance at a lower interest rate.

Transfer to a grantor retained annuity trust. GRATs are designed to remove assets from your estate with minimal gift-tax consequences. You transfer income-producing property to an irrevocable trust, which pays you an annuity. Whatever remains in the trust at the end of its term goes to the beneficiaries you've chosen.

Because you've made a gift of assets to the trust and, ultimately, to your beneficiaries, gift tax may apply. But rather than basing the tax on the actual value of the assets transferred when the trust expires, the IRS calculates what that remainder would be after deducting the value of the annual payments you receive and assuming the assets appreciate at a specified interest rate. Here, too, if the

actual return on trust investments exceeds the IRS assumption, the amount that's transferred to your beneficiaries will exceed the amount that was subject to gift tax. (For a

GRAT to work, you must outlive the trust term; otherwise, the assets go back into your estate.)

Normally, a GRAT involves paying some gift tax. But thanks

to a 2002 U.S. Tax Court decision, it's possible to "zero out" the value of your gift so there's no gift-tax liability. In a zeroed-out GRAT, the value of the annuity payments you're scheduled to receive equals the IRS-calculated value of the trust assets; it's assumed that there won't be anything left for beneficiaries at the end of the trust's term, and no gift means no tax. But again, if assets appreciate at a rate above the AFR, there will be a gift, though still no tax.

Transfer to a charitable lead annuity trust. This works much like a GRAT, except that assets are transferred to a trust that benefits a charitable organization. During a specified term or for the rest of your life, the charity gets income from the trust. At the end of the term or upon your death, the assets go to beneficiaries you choose. You get an income-tax deduction based on the present value of the projected income the charity will receive, and a low AFR translates into a high present value. A low AFR also means a smaller remainder that will be subject to gift tax. When funding a lead trust, you can use the IRS interest rate for the month the gift was made or for either of the two prior months.

These are complex estate-planning vehicles, but we can work with your attorney to determine if they would be a good fit for you. Keep in mind that legislative proposals greatly influence the dynamics of these techniques, so call us to discuss the latest developments. ●



months. And more than 24,000 Lehman executives and workers may have lost most of their savings when their employer went bankrupt.

That's the double whammy—losing a job and your savings—that can hit people who devote too much of their portfolios to shares in their own companies. What can make matters even worse is a tendency to invest additional assets in the same industry. Imagine the Bear Stearns employee who had supplemented a retirement plan loaded with Bear stock with holdings in Lehman Bros. and Merrill Lynch.

Companies, of course, tend

to encourage employees to invest where they work, often matching 401(k) contributions and paying bonuses in company shares. They may also restrict workers from diversifying out of concentrated positions. Yet, as these unfortunate examples prove once again, finding a way to create a broadly diversified retirement portfolio needs to be every investor's top priority. There are many ways to mitigate an over-reliance on stock in your company, and we can work with you to make sure you won't suffer the same fate as your firm if it's pulled down during these difficult times. ●

Your 529 Savings Plan

(Continued from page 1)

of investments, others provide a broad range of choices. In some cases, your money will be managed as part of a state pension fund. Other possibilities include age-based portfolios that dial down risk as a beneficiary approaches the start of college; static portfolios pegged to investors' risk tolerances or classified by asset type (equity, fixed-income, balanced); menus of individual index or actively managed mutual funds; and money market funds. You'll want a plan that gives you well-diversified choices from a well-regarded fund family. And again, low expense ratios are essential.

Perks for state residents. Many states make plans available to out-of-

staters; but all else being equal, an in-state plan may be preferable since it often provides tax deductions or credits for contributions and even contribution matches for low-income residents.

Other advantages/disadvantages.

Most 529 plans let you enroll, fund plans, and check balances on the Web. A few plans restrict ownership changes, and a handful of states let out-of-state enrollees pay in-state tuition. Some plans have agreements with outside credit-card rewards or scholarship programs that can add to savings.

All of these criteria, useful for evaluating a prospective plan, can also help you gauge the effectiveness of an existing 529 plan. If yours comes up short, plan-to-plan transfers are usually allowed once every 12 months, and you can establish multiple accounts

with different plan sponsors for a single beneficiary. You may also want to explore other savings vehicles like Upromise.com, where you get a kick-back for consumer products that you buy. ●

You should consider a plan's investment objectives, risks, charges, and expenses carefully before you invest. The issuer's official statement contains this and other information about the plan and should be read carefully before investing. Investors should consider whether the investor's or designated beneficiary's home state offers any state tax or other benefits that are only available for investors in such state's qualified tuition program. A prospectus may be obtained from your advisor or from the fund company directly.

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