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BFAS Money Line

INVESTMENTS

Prosperity Around the Corner?

My former financial advisor got me into Technology, somewhere around the top, ...So I got him into Real Estate, somewhere in New Jersey

Ezra Solomon once said, "The only function of economic forecasting is to make astrology look respectable."

Many economists have pointed out that six straight Federal Reserve rate cuts almost always presage a bull market. Analysts, nostalgic for the spectacular gains in technology stocks during the late 1990's, predict a near-term, vigorous rebound.

My crystal ball is pretty cloudy, but I remain concerned that the price-to-earnings ratio on the market is still a high 28 (historical norm 14 –16). Does that mean I expect the market to drop to 7000? I certainly hope not!

However, the lackluster earnings outlook seems to put a damper on high growth. **One scenario we might see is several years of slow returns that will allow earnings to catch up to currently high prices**. I think there is a small possibility of high growth as well as continued negative growth. Long-term, the market should continue it's historical growth rate of 11%.

Of course, the turmoil in the Middle East could really set back our economy and the stock markets. If war should break out, the U. S. could well be pulled in to prevent Israel from being overrun by Egypt, Syria and Iraq. Even a supporting role could trigger an oil embargo with serious consequences to our economy.

As you can see in the following table, **value stocks and bonds continue to do well in this uncertain market**. Even a spring rally could not overcome last year's losses.

Asset Class	1 Yr Return (7/31/01)
S & P 500	-14.32%
NASDAQ	-46.19%
Lg Cap Gwth	-26.29%
Lg Cap Val	+17.51%
Mid Cap Gwth	-9.02%
Mid Cap Val	+35.51%
Sml Cap Gwth	-4.76%
Sml Cap Val	+31.78%
Foreign	-21.71%
Interm Corp Bds	+12.50%
Foreign Bds	+1.53%

Just remember, the current market is on sale. If the

Dow will be 20,000 in 2011 (a 7% return), wouldn't you want to be invested now?

TAXES

New Tax Rules

The new tax-cut law is too complicated to cover in any detail, so I will just touch on some high points.

Although the reduction in income taxes and estate taxes got most of the press, there were **significant changes in pension opportunities and education savings** as well.

Put More In Savings

Starting next January, you will be able to divert more money than ever before to your pension plans. **In 2002, the contribution limit on your SEP IRA/401k/403b/457 plan increases to $11,000.** The **SIMPLE IRA limit raises to $7,000 and the ordinary IRA/Roth IRA limit goes to $3,000**.

Each year thereafter, the limits increase until 2006 when the limits will be $15,000 for SEP IRA/401k/403b/457 plans, $10,000 for SIMPLE IRAs and $4,000 for ordinary IRAs/Roth IRAs ($5,000 in 2008).

Catch Up On Savings

Even more important for those of us over 50 is the new catchup provision. It was actually **inserted to help women who dropped out of the workforce during child-raising**, but we men can use it also!

If you are over 50, you can add an extra $1,000 to your normal SEP IRA/401k/403b/457 contribution next year (total $12,000) or an extra $500 to your SIMPLE IRA/ordinary IRA/Roth IRA. Yearly increases in the catch-up mean that, by 2006, you can add another $5,000 to SEP IRA/401k/403b/457 plans, $2,500 to a SIMPLE IRA or $1,000 to other IRAs. Thus, in 2006, you will be able to contribute $20,000 to your 401k plus $5,000 to your Roth IRA.

Rollover Everything

You also get more flexibility. **Rollovers will be allowed between 401k/403b/457 plans**. Since 457 plans have been notoriously restrictive, this is really significant.

Spouse Can Save More

Another potentially significant item is a provision increasing contributions to 25% (from 15%) for defined contribution plans (such as 401ks). Along with the new maximum $200,000 of covered income, this means the maximum contribution can now be up to $40,000. This should allow business principals to shelter more in their retirement plans (subject to highly paid employee testing).

In 2002, the combination limit of employee and employer contributions to 401k/403b/457 plans has increased from 25% to 100% of compensation. This could help out many spouses. **Sometimes a spouse works because he or she wants to, rather than because the family needs the extra income**. In the past the spouse's income seemed to only increase taxes and child care costs. Now, if they make over $12,000 (and they are over age 50) instead of putting only $1,800, they may be able to put all $12,000 into a 401k/403b!

Tax Credit for Saving!

There is also **a tax credit for low-and-moderate income people to encourage their contributions to retirement plans**. The credit, applied to the first $2,000 in savings contributions (401k/403b/457/IRA), would be in addition to the deductibility already available!

Credit	Single	Joint
50%	$0 - $15,000	$0 - $30,000
20%	$15,001 - $16,250	$30,001 - $32,500
10%	$16,251 - $25,000	$32,501 - $50,000

This is **information you need to share with your children as well!** Not only do they pay no taxes on their contributions, but they also get a tax credit. You might even consider gifting to match contributions so they maintain their living standard while building their retirement nest egg.

Small Business Credit

Finally, they also set up an incentive for small businesses with no retirement plan to set one up. A **small business can receive a nonrefundable credit for 50% of the first $1,000 in**

administrative and retirement education expenses for a NEW retirement plan (good for each of first three years of plan).

Education IRA

Education was a major focus of the new tax law. The Education IRA was dramatically overhauled. As of **2002 you can contribute up to $2,000 with the income limits for contributions raised to $95,000 - $110,000 for singles and $190,000 - $220,000 for couples**.

Withdrawals will be tax free and can now be used for K – 12 tuition, computer technology or equipment or Internet access and even actual living expenses for college in addition to tuition and fees.

529 Plans

That tax free distribution also applies to the state 529 (educations savings) plans (as well as pre-paid tuition plans). The tax free growth makes the 529 plan tough to beat. Most states also provide a tax break for contributions to these plans. **Virginia provides a tax deduction of up to $2,000 per year per plan (with excess contributions carried over).**

Thus, if you set up four plans you get $8,000 off your state taxable income for a total tax break of $460 (5.75% times $8,000). Even better for those **over age 70, you get the full deduction in the year of contribution; you don't have to do it $2,000 at a time.**

As more people become aware of 529 plans, they are becoming very popular. However, up until recently, people working with brokers seldom heard of them. That's because the brokers made no money by recommending them and lost commissions on money you put into the 529 plan.

Lately, several states have established 529 plans that provide commissions to brokers who recommend these plans. The following table shows what a broker gets:

Class	Commission	Annual Svc Fee
A	3.5%	.25%
B	2.5% back load	.25%
C	None	.50%

Only some states have these plans. Rhode Island is one of them. I have already seen Virginia residents being sold the Rhode Island plan (which costs more than the Virginia plan, due to the commissions).

Since Virginia residents get a $115 tax refund for a $2,000 contribution, and the cost is less, I find it hard to understand how purchasing a Rhode Island plan is better for a Virginia resident. I know it's better for the broker! Beware!!

Estate Taxes

The gradual increase in the estate tax exemption (it was going up to $1,000,000 by 2006) was greatly accelerated. The **$1,000,000 exemption starts next January, increases to $1.5 million in**

"Dow Jonesy enough for you?"

2004, $2 million in 2006, $3.5 million in 2009 and unlimited exemption in 2010. There is a sunset provision that says, in 2011, we revert back to our current estate tax regime.

This dramatic reduction in estate taxes means fewer and fewer people will be paying estate taxes in future years. **Unfortunately, many people assume they no longer need to do estate planning**. Several lawyers have told me this is already happening. Nothing could be further from the truth!

The **real reason to do estate planning is to make sure everything you accumulated during your lifetime goes where you wish after you are gone**. Without estate planning, the state may decide where your assets go.

I know some of you think you can save the attorney's fees by leaving money in a joint account with right of survivorship or setting up "Payable on Death" or "Transfer on Death" accounts. These techniques will bypass the probate process, but can lead to other problems.

Putting investments into a joint account can create a gift so that only half of the assets might get a step-up in basis when you die. Also, a joint account with a child puts the investments at risk to the child's creditors, or at risk of being shared with the child's spouse in a divorce situation.

In addition, not everyone who inherits is capable of managing their inheritance. **So, don't be penny-wise and pound-foolish; see your attorney!**

Some of you are saying, "I've already got my estate plan done. I don't need more estate planning."

Many estate plans are written to take advantage of the current exemption amount through the creation of a Credit Shelter Trust. With the exemption amount increasing dramatically, it's quite likely that all of your assets might go to the Credit Shelter Trust.

While most Credit Shelter Trusts specify income, and in some cases, principal available to the spouse, this may not leave any money for the Marital Trust. Thus, the spouse may have no assets of his/her own.

What about the estate tax repeal in 2010 and the sunset provision in 2011? How will that affect your planning? Should it be taken into account?

Although estate taxes are changing, **gift taxes are staying with us**. Sure, you still get the $10,000 annual exemption, but **the lifetime exemption for gifts over the annual exemption stops at $1,000,000**. Lifetime gifting over that amount will be taxed at the maximum income tax rate (35%). This gives those with substantial assets a perfect excuse to limit gifts while living, since repeal of the estate tax eliminates taxes after death!

Irrevocable Life Insurance Trusts (ILITs) with Survivorship Life Insurance policies may need to be re-thought. If you believe the estate tax will really expire permanently, an ILIT will have less value. However, they also provide asset protection from creditors or divorce. If you believe the estate tax will never really go away or you are concerned about asset protection, you may want to retain your ILIT.

DISABILITY

Elderly Parents Protecting Assets

One of the most difficult situations for parents with disabled children is planning for what happens after you are gone. **If you are elderly and have limited means, you may be concerned about using up your limited assets for Long Term Care needs, leaving nothing for your child.**

However, Congress in OBRA '93 specifically allows parents in this situation to **place their assets into a (d)(4)(a) Trust for their child and immediately qualify for Medicaid support of Long Term Care**. Normally, placing money into a trust would eliminate Medicaid access for five years.

This can significantly help elderly parents.

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