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NAPFA

Planning Perspectives



Taking Stock at the End of the Year

The end of the year and the holiday season are a good time to look back on our recent past and to anticipate the year ahead. For our personal finances, we can consider some of the lessons we've learned, and we can commit to wiser savings and investment strategies, and to getting more enjoyment from our spending.

This issue of NAPFA Planning Perspectives offers a look at new federal tax breaks that will begin in 2006, and also at the prospects



for broader tax reform. We also explain how to get rid of much of your pesky financial paperwork, while remaining confident that you are keeping the truly important information. And finally, we suggest how you can spend in the future to add more meaning to your life.

NAPFA Develops Consumer Checklist and Diagnostic

To better assist individuals in selecting an appropriate financial advisor, NAPFA is developing two new information products that will be available in January.

The Comprehensive Financial Planning Checklist is a single-page form that can be used for the initial screening of potential advisors. In as little as 10 minutes, you can ask a few well-targeted questions to find out which services the advisor is offering and how he or she is compensated.

For advisors who pass your initial screening, NAPFA's Comprehensive Financial Planning Diagnostic will help you get more in-depth information about which advisor would be a good

long-term partner for you and your family. The Diagnostic first asks for basic details about the advisor's experience and training, fees and fee structure, etc. But then it goes deeper. For example, will the advisor work directly with you, or will most of the work be done by associates or assistants? Finally, the Diagnostic helps you interpret the answers you receive...and identify what you should be looking for in an advisor.

Go to NAPFA's Web site, www.napfa.org, find the link for Consumer Information, and print your copies of NAPFA's Checklist and Diagnostic.



Investments

What Your Advisor Doesn't Want You To Ask

By David John Marotta, AAMS, AIF®, NAPFA-Registered Financial Advisor, www.emarotta.com

Probably the most important question you can ask of anyone offering you financial advice is, “Do you have a legal obligation to act in my best interests?”

That question is at the heart of the federal exemption that allows stockbrokers to be able to offer the same services as Fee-Only financial planners without being accountable to the same fiduciary standards.

The term “fiduciary” applies to the more than 5 million individuals who have the legal responsibility for managing someone else’s money. A fiduciary is required by law to always act in the best interests of his client, beneficiary, or retirement plan participant.

Fiduciary obligations are at the heart of rising criticism of commissioned mutual fund and insurance sales structures, where compensation inherently creates conflicts of interest.

Fiduciary obligations also are at the heart of the Social Security Reform debate. Privatized accounts would be protected by existing fiduciary legislation. Under the current program, the government has no such fiduciary responsibility.

And questions about fiduciary obligations are what many financial professionals fear the most. It is the bright white line that separates those who sit on your side of the table and have a legal obligation to act in your best interests, and those who sit on the other side of the table and have no such obligation.

The Securities and Exchange Commission (SEC) requires that your stockbroker disclose in writing: “Your account is a brokerage account and not an advisory account.” And “Our interests may not always be the same as yours.”

Compare those required disclaimers with the binding commitment of members of the National Association of Personal Financial Advisors:

NAPFA Fiduciary Oath

“The advisor shall exercise his/her best efforts to act in good faith and in the best interests of the client. The advisor shall provide written disclosure to the client prior to the engagement of the advisor, and thereafter throughout the term of the engagement, of any conflicts of interest, which will or reasonably may compromise the impartiality or independence of the advisor.

“The advisor, or any party in which the advisor has a financial interest, does not receive any compensation or other remuneration that is contingent on any client’s purchase or sale of a financial product. The advisor does not receive a fee or other compensation from another party based on the referral of a client or the client’s business.”

More than 20 years ago, NAPFA changed the financial services industry by publicizing the idea of Fee-Only comprehensive financial planning in an industry rife with commission-based and fee-based conflicts of interest. Today, NAPFA and the Center for Fiduciary Studies are the leaders in promoting the concept of fiduciary responsibility in an industry of brokerage firms whose “interests may not always be the same as yours.”

Legal and accounting professionals, such as estate planning attorneys and CPAs, also have a responsibility to act in their client’s best interest. Therefore, when making referrals to other financial professionals, they have a legal responsibility to recommend only those fiduciaries that have made the commitment to act solely in your best interests.

When it comes to your money, make certain all of the members on your team of advisors are on your side of the table.

(Note: Some information above has been provided by Fiduciary360, used with permission.)

Commission-based compensation inherently creates conflict of interest.

What the Fiduciary Oath means to you - the client

- I shall always act in good faith and with candor.
- I shall be proactive in my disclosure of any conflicts of interest that may impact you.
- I shall not accept any referral fees or compensation that is contingent upon the purchase or sale of a financial product.



Taxes

Consider these New Tax-Savings Opportunities for 2006

By Louis Kokernak CFP, CFA, NAPFA-Registered Financial Advisor
www.havenfinancial.com

Although there has been significant attention to President Bush's Advisory Panel on Tax Reform, those proposals are likely to be enacted far in the future, if ever. (See [Tax Reform article](#))

Here are important tax law changes that will take effect on Jan. 1, 2006.

Roth 401(k)

In 2006, plan sponsors will be able to amend their 401(k) plans to allow participants to make after tax-salary deferrals to an investment account that will shelter any future gains from taxation. The self-employed and sole proprietor also can take advantage of the Roth 401(k)'s great potential for retirement savings.

Unlike the current Roth IRA, there is no income limit for a Roth 401(k); everyone qualifies for contributions. Secondly, the allowable contribution limits are generous: \$15,000 in 2006, plus \$5000 in catch-up provisions for participants who are 50 and older.

But be careful. Roth contributions are irrevocable; once they are allocated to a Roth 401(k) account, they cannot be shifted to a pretax account. Tax-deductible employer contributions will continue to be made to the pre-tax account. After leaving an employer, the participant can roll Roth 401(k) assets into a Roth IRA, and traditional 401(k) funds into a regular IRA.

It is noteworthy that, under current law, the Roth 401(k) sunsets after 2010. That still leaves 5 calendar years of excellent tax shelter opportunities. If an individual contributes \$15,000 annually during those 5 years and earns 8%, the Roth 401(k) will accumulate nearly \$300,000 by 2025!

While the Roth 401(k) is generally superior to the traditional 401(k), this is not uniformly the case. In principle, the difference between the two is that the Roth is a pay now/enjoy later arrangement, and the traditional 401(k) offers immediate shelter at the cost of converting future gains to ordinary income. If a plan participant

believes that his or her current tax rate is higher now that it will be in the future, it may make sense to take current tax deductions. Yet the mathematics favoring the Roth 401(k) are fairly robust even under varying economic scenarios.

So far, employers have been slow to adopt. Only about one-third responded positively to a Hewitt Associates survey as to whether they would offer a Roth 401(k) in 2006.

Self-employed individuals should check with their financial advisor or custodial firm where their investments are held (Charles Schwab, TD Waterhouse, etc.) to find out if the Roth 401(k) is available to them yet.

Tax Credits for "Green" Behavior

In a period of high energy costs, tax credits for energy-conscious homeowners and car buyers are especially welcome. In 2006, homeowners will be able to claim up to \$500 in tax credits for home improvements that reduce energy consumption. Covered items include hot water heaters, new windows, doors, and skylights.

Also, installation of solar paneling to generate electricity can earn a tax credit for up to 30% or \$2000 in 2006. Many cities already subsidize eco-friendly home improvements, further reducing an individual's costs.

In my town, Austin, Texas, local utility Austin Energy provides one of the highest solar rebates in the country at \$4.00 per watt (\$4.50 for nonprofit organizations). This rebate level will pay between 45% and 75% of the cost of installation of a solar system. With the tax credit and city rebate in effect, the cost of solar paneling could be reduced up to 80%.

The federal tax subsidy on the purchase of hybrid cars will increase next year as well. Buyers of hybrids in 2006 are eligible for tax credits based on the fuel efficiency of the vehicle. A Toyota Prius pegs the scale with an estimated tax credit of \$3150, while the Honda Accord Hybrid should generate a credit of \$650.



In a traditional 401(k), contributions reduce current tax obligations, but withdrawals are taxed. In a Roth 401(k), contributions do not reduce current tax obligations, but withdrawals are not taxed. So earnings accumulate tax-free.



Taxes

Don't Count on Tax Reform Yet

By Robert Justice, NAPFA-Registered Financial Advisor;
www.mbdworld.com

During his re-election campaign, President Bush announced that tax reform would be a priority during his second term. On Jan. 7, 2005, a bipartisan panel was created via Executive Order to advise Treasury Secretary John Snow on options to reform the tax code to make it simpler, fairer, and pro-growth.

Without a doubt, there are improvements to be made in an Internal Revenue Code that, according to the White House:

- contains more than 1 million words;
- has more than doubled in length over the past 20 years;
- now has a “short” income tax form that takes an average person 11 hours to prepare (about the same as the “long form” did a decade ago); and
- will, by 2010, force more than one in five taxpayers to calculate their income taxes twice—once for the regular income tax and once for the Alternative Minimum Tax—and then pay the greater amount.

In early November 2005, the panel issued its recommendations. It is expected that the Treasury Department will use the proposals as a base for the recommendations it will make to the president in early 2006.

The panel’s recommendations are arranged into two plans, referred to as the Simplified Income Tax Plan and the Growth and Investment Tax Plan. Although both plans preserve the basic income taxation of wages and investments, there are many differences.

The panel also considered a consumption tax, a value-added tax and a national sales tax, but was unable to reach a consensus on any of the three.

The following chart compares some of the more significant changes proposed in the plans.

Tax Attribute	Simplified Tax Plan	Growth & Investment Plan
Tax Rates	Four Brackets – 15%, 25%, 30% and 35%	Three Brackets – 15%, 25% and 30%
Alternative Minimum Tax	Repealed	
Home Mortgage Interest	Deduction will be replaced by a credit available to all taxpayers, equal to 15% of interest paid. Deduction for interest paid for second homes and interest on home equity loans will be eliminated.	
State and Local Taxes	Not deductible, including income and real property taxes	
Charitable Contributions	Deduction would be available to all taxpayers that give in excess of 1% of their income.	
Health Insurance	Employer-provided insurance would be excluded from income up to \$5,000 annually for individuals and up to \$11,500 for families. All others would receive a comparable deduction.	
Interest Received	Taxed at regular rates	Taxed at 15%
Dividends Received	Excluded if received from U.S. company paid from domestic earnings	Taxed at 15%
Capital Gains Received	Excluded 75% if received from U.S. company paid from domestic earnings	Taxed at 15%

Special interest groups, politicians, business leaders, and taxpayers have been quick to respond to the basic proposals. The flashpoints, obviously, have been the elimination of the deduction for state taxes and property taxes and the proposed credit for mortgage interest paid.

U.S. Rep. Sam Johnson (R-Texas) told the *Dallas Morning News*, “These suggestions are dead on arrival. We won’t tamper with these middle-class deductions.” From the other side of the aisle, the view was similar. U.S. Rep. Eddie Bernice Johnson (D-Texas) said, “I do not understand how a panel assigned to recommend a fairer tax code could strike at the heart of what makes home ownership most affordable among middle-class families.”

Given the initial response from lawmakers, it is obvious that there will be much debate before our current system of taxation is supplanted with one that satisfies the president’s requirements.





Living Your Life

Keep or Toss Those Papers?

By Robert R. Reed, Ph.D., CFP® NAPFA-Registered Financial Advisor, www.reedplanning.com.

We are being buried in ever-mounting piles of paper, and we are afraid to dig our way out. Just as we are about to toss something in the trash, a nagging voice in our head whispers, "Careful! It might be important."

Relax. A lot of it isn't important. Throwing away documents you might need later is bad, but it's also bad to keep so much stuff that you have no idea what you have or where it is. It might as well be gone.

If the end of the year is a time when you like to do some house-cleaning and junk removal, here's a general guideline to help you decide what to keep and what to toss (and when).

Keep Forever (unless no longer in force)

- Birth and death certificates.
- Home improvement receipts. Keep for large permanent improvements such as a room addition. These reduce your capital gain when you sell.
- Home purchase or refinance. Keep until you sell your house.
- Current insurance policies. Keep the original policy and latest renewal statement.
- Nondeductible IRA contributions. You need to show that you already paid tax on the contributions so the IRS can't tax them again when you make a withdrawal.
- Legal documents (wills, trusts, financial and health-care powers of attorney, living wills, real estate deeds, marriage certificate, and divorce papers). It is a good idea to keep copies of these with your attorney or a relative, and to leave a record where the copies are.
- Government-issued ID. Includes Social Security card, Medicare card, military discharge, passport.

Keep Less Than Forever

- Auto and driver's license. Keep your driver's license, even if you don't drive any more. It is a generally accepted ID. Keep your car title for as long as you own the car.
- Bills. Keep for major purchases to show proof of their value in case of loss or damage. For all others, throw them out after the payment has cleared, the refund period expires, or you no longer have the item.
- Credit card receipts and statements. Keep your receipts until your monthly statement arrives. If it is correct, toss the receipt. Keep a receipt if you are disputing the bill. Keep statements for six years if they contain tax-related items.
- Bank statements. Don't keep these unless it involves taxes. If someone disputes receiving a payment from you, you can always get a copy from the bank.
- Mutual fund and brokerage statements. Keep monthly/quarterly statements until you receive your annual summary. If everything is OK, toss the quarterlies. Keep annual statements until you close the account (mutual funds) or retire (retirement account statements).
- Pay Stubs. Keep until you get your W-2. If the numbers are correct, toss the stubs. If your company lists vacation/sick leave carryover on your stub, keep the year's last stub until your last stub of the following year. Notify the company if the information doesn't match.
- Tax documents. Keep a copy of your returns, attachments, and all documents used to prepare the return. The IRS can only go back 3 years to question a return unless the agency believes there was deliberate fraud. Then there is no time limitation. If you worry, keep tax records forever. After 3 years, just put them in a box in the attic.



"We can lick gravity, but sometimes the paperwork is overwhelming."

- Rocket scientist
Wernher von Braun



Living Your Life

Buy Experiences and Invest in Rich Memories

*By Kathleen M. Rehl, Ph.D., CFP®,
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This past fall, my husband and I brought our three adult sons and a daughter-in-law together for a family retreat. We rented a house along the shores of Lake Michigan, near a friendly small town. A lighthouse and a boat-filled harbor were nearby, and the town offered many special attractions: a beautiful, extended sandy beach; interesting ethnic food; an outdoor music festival; gorgeous evening sunsets across the lake; and an art gallery.

Most importantly, the retreat was a wonderful time to affirm and strengthen our family bonds. We walked and talked along the beach, lingered in conversation over cups of fragrant tea and chocolate chip cookies, laughed at photos in old family albums, shared stories about the kids' dreams for their futures, giggled over silly games of dominos, and so much more.

Indeed, before the concluding day of our family gathering, everybody agreed that we've started a new tradition. We've already selected tentative dates for next year's reunion, and we've identified another part of the country we want to explore together for several days.

My husband and I picked up the total tab for the weekend expenses (including transportation costs for everyone) because we knew we would get a great return on this type of "investment." It was our gift to our family. All of us have wonderful memories of this event that will stay with us for a long time.

As you see your families during this holiday season, you might want to think about how you can spend some of your own money to "buy" experiences and "invest" in rich memories. Forget for the moment the futility of buying "stuff" to please children, parents, or siblings who probably don't need more things. Instead, consider "purchasing" a special event, an interesting adventure, or a shared activity that can result in happy memories that last a lifetime. This is truly a gift that keeps on giving.

