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WEALTH MANAGEMENT ADVISOR

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Are they ready for the real world?

Financial advice for recent grads and other young adults

Your daughter may be proud of her recent college diploma. But has she passed Personal Finance 101? Unfortunately, too many young adults — and not just the most recent college graduates — aren't financially ready for the real world. And making poor choices early in one's adult life can take a lifetime to reverse.

Smart financial advice is one of the greatest gifts you can give your children or grandchildren. Here are some important tips to pass along to the young adult in your life.

Developing a savings habit

If your loved one received graduation cash or a signing bonus for a new job, suggest building a nest egg. Long after technological toys or new clothes are forgotten, savings will be there — quietly growing and waiting to be put to good use.

You can provide examples of how a nest egg means more freedom — freedom from worry about an unexpected job loss, a rent increase or expensive car repairs. Having savings also means being able to afford future dreams, such as a down payment on a home or a European vacation.

The best way to become a prolific saver is to get in the habit of putting away a portion of every paycheck — no matter how small — and have it deposited automatically into a savings, investment or money market account. The most important thing is to stay disciplined and increase savings whenever possible. At the very least, everyone should consider saving enough to cover six months' worth of expenses.

Resisting temptation

Most of us can't buy everything we want, though too many of us spend money we can't really afford. Help your recent grad understand that the true cost of an item isn't just the amount on the price tag; it's also the amount of any credit card interest, plus the cost of not saving the amount equivalent to that purchase.

Credit card debt is, of course, one of the worst financial traps young adults can fall into. The odds are stacked significantly in the credit issuer's favor, and trying to undo credit report damage from a series of missed payments can take years. Your recent grad will receive plenty of credit card offers. Help him or her understand how important it is to pay bills on time and, if possible, in full every month.

Time is on their side

Young people don't always have much money to invest, but they do have an even more valuable asset — time.

By taking advantage of their youth, they can accumulate a lot of money for future financial goals. The best way to do this is typically through an employer-sponsored retirement plan, because the money goes in pretax, and grows tax-deferred. Plus the employer may offer matching contributions.

Help your college grad look for ways to make the investing process as easy as possible — through automatic investment plans, offered by most companies that offer mutual funds, or employer retirement accounts funded through paycheck deductions.

An exciting new chapter

Many congratulations are due to recent college grads and young adults beginning their careers. To ensure they make the most of their education and talents, help them understand the value of smart financial decisions. ■

Minimize the Social Security tax burden without minimizing benefits

Income earners are subject not only to federal and state income taxes, but also are required to contribute to the Social Security system. These contributions can be made by employees in the form of FICA payroll withholding or by the self-employed on their annual income tax return.

These two methods of contributing are, in fact, equivalent, although the burden can seem weightier for the self-employed. Employers cover half of their employees' Social Security contributions. The self-employed — including partners in a partnership or members of a limited liability company — must pay both halves of their own tax. With careful planning, however, you can minimize this self-employment tax bite.

A bigger bite

If you pay your own Social Security tax, keep in mind that a dollar of self-employment income is never worth quite as much as a dollar paid by an employer. Up to the FICA limit of $94,200 in 2006, it takes slightly more than a 9% increase in gross income to make the self-employment income equivalent.

When you calculate the income tax deduction self-employed individuals receive for half of their self-employment tax, it comes to approximately a 6% to 7% difference. For example, $53,000 of self-employed income is roughly equivalent, after taxes, to $50,000 of salary from an employer.

The legal form of your business can affect the amount you pay in Social Security taxes. While limited liability companies (LLCs) have become popular because of their greater flexibility, traditional S corporations offer a better opportunity for working owners to minimize Social Security taxes.

With partnerships or LLCs, all of the income allocated to a working owner is considered self-employment income. By contrast, an S corporation owner need only pay a "reasonable" salary to him- or herself — but not necessarily all of the company's income. The balance of the income not paid as salary is taxed to the owner for income tax purposes, but not as self-employment tax. Remember that, while FICA contributions top out at $94,200, the Medicare tax of 2.9% is based on an unlimited amount of earned income.

If you are an S corporation owner and also receive rental or interest income from the business, you may be able to adjust your income between the categories, keeping salary low and other amounts higher.

The legal form of your business can affect the amount you pay in Social Security taxes.

Reduced benefits?

Generally, reducing the portion of your income that's treated as salary or self-employed income reduces what you owe to the Social Security and Medicare systems. While this has the advantage of lowering your taxes, it can have some negative consequences.

It may reduce the amount of retirement plan contributions that can be made by you or on your behalf. It may also affect state taxes due (such as on net S corporation income) and may even have an impact on the manufacturers' deduction, because that deduction, new in 2005, is based on a percentage of qualified *net* income of the business derived from manufacturing activities. Thus, every dollar of salary taken by an owner actually reduces this deduction.

And what about the Social Security benefits you hope to enjoy when you retire? In theory, these benefits are accrued based on the amount you and your spouse earn every year. But while reducing your earned income today may cost you a little, it probably isn't significant enough to discourage you from reducing current taxes. The benefits you eventually receive will be based on many factors, including how long you and your spouse live, at what age you begin accepting benefits and your total history of earnings.

Even though you qualify for full Social Security benefits after only 40 calendar quarters of work, your earnings history over 35 years is measured to determine how much you receive in benefits. Benefits build up at a higher percentage on the first dollars of earnings.

This might seem to suggest you'd benefit from shifting some of your income to your lower-earning spouse. But keep in mind that you receive benefits based on 50% of your spouse's benefits if it represents a greater amount than what you would receive on your own. The system is generally designed to prevent a small difference in amount of earned income from having a major impact on your benefits.

Take a close look

Planning to minimize your taxes while maximizing Social Security benefits can be a complicated process. No one rule fits all; only a close and careful look at your particular situation and that of your business will help you arrive at the appropriate solution. ■

What to look for in a mutual fund

With more than 8,000 mutual funds available to individual investors, how do you decide which ones deserve a place in your portfolio? This is an important decision, but it doesn't have to be overwhelming. Some simple guidelines can help you make smart choices.

Recognize your goals

Start by considering why you're investing. If you need to build assets for a distant financial goal — such as retirement — you may favor capital-appreciation-oriented stock funds, which historically have generally outperformed most other investment types. If, however, your goal is regular income or capital preservation, a greater weighting to bond or money market funds might be a better fit.

Understand that the greater growth potential of stock funds is accompanied by an increased risk of loss. While most fixed-income funds are less volatile, even these carry investment risk and do not protect against possible loss of principal. And, whatever your goals, designing a well-diversified portfolio with the proper mix of stocks and bonds, and covering all segments of the market, can be beneficial.

Check performance

When comparing funds, review their historical performance over the past one, three, five, and, if the fund is old enough, 10 years — giving greater weight to long-term performance. Then measure these results over the same periods against those of relevant benchmarks.

If, for example, you're assessing a large-cap stock fund, the S&P 500 Index, which measures the performance of 500 large U.S. companies, is likely a good reference point. This index, however, won't be much use if you're evaluating the performance of a real estate or bond fund. For those, there are more specialized indexes, such as the Lehman Brothers Aggregate Index and the Dow Jones Wilshire REIT Index. Keep in mind that indexes are unmanaged and that you can't directly invest in an index. Also, past performance isn't indicative of future performance.

When reviewing performance of an actively managed fund, don't forget to look at the portfolio manager's tenure at the fund. Ten years of benchmark-beating results may seem to indicate a must-own fund until you learn the current manager has been at the helm for only six months.

Consider your risk tolerance

We're not all the same when it comes to our comfort level with risk. Before you purchase an aggressive growth fund, ask whether you could handle losing some or all of your original investment. If not, you may be better off buying a less-volatile option — perhaps an equity fund with a high dividend yield, a bond fund or a money market fund, depending on your investment goals.

But if you're comfortable with the idea of risk — or if you're investing for a goal that's well in the future — you're probably better off accepting higher short-term volatility for increased return potential.

Read the prospectus

While many financial information providers can give you benchmark and other vital fund information, it's important to review a fund's prospectus and shareholder reports. *The prospectus will tell you about a fund's investment objective, risks, charges and expenses, and basic management strategy. You should read this material carefully before investing or sending money.*

Shareholder reports update you on recent and historical performance and describe in detail how the managers approached their job during the past period. Remember, past performance doesn't guarantee future results.

Fund company publications will also disclose costs related to the fund's management and operation. This is one of the most important factors in determining how it will perform over the long term. All else being equal, funds with low expenses are generally preferable to their high-cost counterparts. This doesn't mean that funds with low expense ratios are always better — some high-cost funds do very well and some low-cost funds are poor performers.

Get some advice

Everyone's situation is different, which is why you may want to discuss mutual fund options with your financial professional. He or she can help you choose not just one mutual fund, but an entire portfolio of investments designed to complement one another. ■

State inheritance taxes: An often-overlooked planning issue

While taxpayers are grappling with the uncertain future of federal estate tax rates and exemptions, they may have failed to notice major changes in state inheritance and estate taxes. The federal estate tax credit for state estate taxes was phased out over a four-year period and disappeared completely on Jan. 1, 2005.

When the full federal credit was still available, individuals with large estates could ignore state taxes for estate planning purposes because the federal estate tax credit fully offset the state liability. Now, however, taxpayers living in some states should consider taking steps to minimize or, if possible, eliminate this potential tax burden.

Are you vulnerable?

Because many state tax systems were based on the amount of the federal credit, these taxes disappeared when the federal credit was eliminated. But some state tax laws had been worded in a way that insulated them from alterations in federal tax policy.

Other states made changes in their laws to preserve or restore the tax in the post-federal-credit era. Even if you live in a state that no longer has a tax, you may own property in a state that does, and your estate will be subject to that state's tax.

The federal deduction that has replaced the credit beginning in 2005 helps some, but current state taxes can still have a big impact. If, for example, your estate is taxed at a 45% federal rate and state taxes are calculated to be $200,000, the federal deduction saves only $90,000 ($200,000 times 45%) and the net state tax cost to the estate is $110,000.

Reducing exposure

If the size — currently larger than $2 million in most states that have a tax — and location of your estate subject you to state estate taxes, you can possibly reduce your exposure. First, consider a change of residence to a state such as Florida, Arizona or California, which don't currently have state estate taxes.

If you own more than one residence — one in a non-estate-taxing state — and split time relatively evenly, you might shift your primary residence. This could entail some relatively minor adjustments such as changing voter registration, obtaining a new driver's license in that state and redirecting your incoming mail to that address.

Of course, you'll also be shifting your state of residency for income tax purposes, and higher income taxes could offset anticipated estate tax savings. Before you switch your state of residency, compare the income tax rates in each state, find out whether either state taxes retirement plan distributions and determine whether you will benefit from the federal tax deduction given for state income taxes paid.

Other reduction measures

Another method of potentially reducing state estate tax is to make gifts shortly before death. Traditionally, this hasn't been an effective means of reducing estate taxes because such gifts — with the exception of annual exclusion gifts of up to $12,000 per recipient — have been included in the estate for federal estate tax purposes.

But most states that have an estate tax don't have a gift tax. Therefore, a gift in excess of the annual exclusions may reduce your estate's state tax burden even though it gets added back into the taxable estate for federal purposes. If the amount of the gift is substantial, the tax impact could be significant.

Finally, if other factors such as income tax rates are equal, there could be some benefit to recognizing income during your lifetime when the income tax payment will reduce the taxable estate for both federal and state purposes.

The bigger picture

None of these steps should be taken without careful consultation with tax, legal and financial professionals. Before you do anything as dramatic as changing your state of residency or making a large gift, be sure you've assessed the possible effects on your larger estate and tax goals. ■

Umbrella policies can mean extra protection

You never know when you could wind up the target of an expensive lawsuit. Consider these scenarios, any one of which could potentially be financially ruinous:

- **Your dog attacks a neighbor, who is so badly injured he can't work for months afterward.**
- **Your teenage daughter injures a pedestrian while driving to the mall.**
- **Your largest tree falls onto an adjacent home, causing extensive damage.**

These situations are rare, but they do happen. An umbrella insurance policy can be an effective and relatively low-cost way to potentially protect you and your family from financial ruin.

Affordable and comprehensive

Umbrella insurance supplements the liability coverage offered by your homeowner's and automobile policies and also covers things they don't.

Say you're facing a multimillion-dollar lawsuit related to your home, but your homeowner's insurance provides you with only $500,000 of liability protection. The $500,000 would be covered by your homeowner's policy, while your umbrella insurance would likely cover any additional liability, up to your policy's limit.

Because umbrella coverage doesn't kick in until you've exhausted your other coverage, it's usually affordable. Also, many insurance companies offer discounted premiums on umbrella coverage if you buy it with home and auto policies.

Umbrella insurance coverage is relatively comprehensive. It can be used to pay medical bills, rehabilitation costs and lost income for someone who's injured as a result of your negligence. It also can cover legal fees if you need to defend yourself in court.

But there are a couple of significant exceptions. It doesn't typically cover liabilities arising from business-related activities or from serving on a board of directors. For these, you'll need separate business policies. Also, your umbrella insurance may not cover punitive damages arising out of a lawsuit.

How much is enough?

When determining whether you need umbrella insurance — and how much to purchase — assess your risk factors. If you live alone and have a history of safe driving, your insurance needs may be less than if you have a larger family that includes teenage drivers. In short: The greater your potential liability, the more important it is for you to be well insured. Greater risk factors will, of course, increase the cost of your umbrella coverage.

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Registered Investment Advisor

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A Certified Public Accountant (CPA), Personal Financial Specialist (PFS) and Certified Investment Management Consultant (CIMC), Jim is the founding shareholder and President of CFSE Wealth Management, Inc. He is actively involved in local organizations including: Morning Star Charities, Inc. (President), Winter Park Chamber of Commerce, the University of Central Florida Golden Knights Club, Winter Park YMCA (Board of Directors), Entrepreneurship Society at Rollins College (Board of Directors) and is an Inductee in the UCF College of Business Administration Hall of Fame.

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Please call us today at 407-629-7008 (Winter Park) or 239-598-3146 (Naples) to discuss your needs, or visit www.CFSEonline.com for more information on our services.

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- Comprehensive Personal Financial Planning
- Tax and Estate Planning
- Asset Allocation Modeling
- Fund Cost Efficiency Analysis
- Manager Search/Selection
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