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WEALTH MANAGEMENT ADVISOR

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How safe are your retirement savings?

Work for a big company, and you'll be taken care of in retirement. That was the conventional wisdom not so long ago, but the sentiment doesn't reflect the reality for most employees today.

Whether you're counting on income from a traditional pension or distributions from a 401(k) to get you through retirement, your money may not be as secure as you think. It pays, therefore, to understand what protections are in place for your retirement savings.

Which type do you have?

There are two main types of retirement plans:

1. **Defined-benefit plans.** These are traditional company pension plans, which promise employees a fixed benefit at retirement. Money in such plans remains under the control of the administering company until it is paid out to employees.
2. **Defined-contribution plans.** Currently, these are much more common. They feature individual employee-owned accounts to which employees and, sometimes, employers contribute funds on a tax-advantaged basis. The most popular variety of defined-contribution plan is a 401(k); others include 403(b)s, 457s, Simplified Employee Pensions (SEPs), Savings Incentive Match Plans for Employees (SIMPLEs) and employee stock ownership plans (ESOPs).

Pension risks

The main risk of a defined-benefit plan is that the plan may turn out to be underfunded and your employer could fail to meet its financial obligations — potentially leading to reduced benefits, especially for highly compensated employees.

Because pension plan assets legally are controlled by the company until they're distributed, your ability to protect your retirement fund is limited. Your best strategy is to pay attention to how the plan is being managed, particularly as you approach retirement. The sooner you spot any warning signs, the more time you'll have to respond.

On request, your employer must provide you with an individual benefit statement and summary detailing the plan's fiscal health. A financially strong plan will have more assets than liabilities. If the opposite is true, try to determine if the situation is temporary or indicates a more substantial problem.

If your pension plan is terminated because of underfunding, your benefits are guaranteed by a quasi-government agency — the Pension Benefit Guaranty Corporation (PBGC) — up to a current maximum of about $3,800 per month. Many fear, however, that the PBGC is itself underfunded and that legislation is necessary to ensure protection will be available for employees of financially troubled companies.

If you expect your benefits to exceed the PBGC guarantee, you might request a lump-sum distribution from your employer when you retire and roll over the funds to an IRA. This approach may reduce the overall amount of income you'll receive but will give you more control over the account.

401(k) risks

The money in your defined-contribution plan, on the other hand, is legally yours — meaning your assets don't depend on your company's continued solvency. Employer theft, however, is an increasingly worrisome risk. According to a recent *Wall Street Journal* article, there were 1,269 cases of defined-contribution plan fraud in 2004, compared to just 34 in 1995.

Theft of retirement savings can be difficult to detect, particularly if you work for a small company. Businesses with fewer than 100 eligible employees aren't required to submit their defined-contribution plans to regular audits.

With no formal protection for losses, recovering missing funds can be challenging. If you find yourself a victim of 401(k) fraud, contact the federal Employee Benefits Security Administration (EBSA), which offers instructions for making a formal complaint. The EBSA's Office of Enforcement will investigate your case and, if necessary, send it for potential action or prosecution by the Solicitor's Office of the Department of Labor. Visit the EBSA Web site at www.dol.gov/ebsa, or call 1-866-444-3272.

Arm yourself with knowledge

Vigilance is your most powerful fraud-prevention tool. Monitor your investment statements and confirm that amounts deducted from your paycheck match deposits in your investment accounts. Also ask work colleagues if they've encountered any problems. Finally, if you are concerned about your retirement plan's integrity, consider rolling over your account balance into an IRA after you've left your job.

For more information about protecting your retirement savings, visit the EBSA Web site. For information about guaranteed pension benefits, consult the Pension Benefit Guaranty Corporation at www.pbgc.gov. ■

Family limited partnerships: Still a viable wealth management tool

Family limited partnerships (FLPs) have enjoyed great popularity as financial planning vehicles for more than a decade — despite attacks by the IRS.

There are a number of reasons FLPs can make good planning tools. Key among them is the fact that partnerships, or limited liability companies (LLCs) that are taxed as partnerships, are a flexible and efficient ownership structure for holding many businesses, real estate, or investments. Partnerships involve flow-through taxation and avoid some of the restrictions imposed on S corporations.

Why they're appealing

An FLP is created when two or more individuals contribute some combination of cash, marketable securities, real estate or closely held business interests to the partnership in exchange for an interest in it. Limited interests are then typically gifted to family members. The general partner or managing member of an LLC controls all decisions regarding its operation and the ultimate distribution of its assets.

As a vehicle for transferring assets from one generation to the next, the FLP has many advantages. For starters, it's usually simple and efficient to transfer assets. Rather than having to make cumbersome transfers of individual securities or interests in real estate to several family members, you can use a one-page document to transfer a certain percentage ownership in an FLP that holds the securities or real estate. This is particularly convenient if you're making transfers to a number of family members over a period of years.

Many people also like FLPs because they allow them to make gifts while retaining control over the assets. As general partner, you not only control how partnership assets are invested, but also when and whether distributions are made to the partners. Many FLPs distribute enough cash to partners to cover the tax liability on their share of the income, though there's no requirement to do so.

FLPs also offer asset protection. Because limited partners can't access the assets they own, their creditors also have difficulty doing so. While creditors can take over an interest in the partnership, they can't force the partnership to make distributions to them. This is true even for general partner interests.

How FLPs are vulnerable to the IRS

The ability to take valuation discounts has also driven much of the popularity of FLPs. Limited partners lack control over their investments; therefore, their interest can be valued at a discount that reflects this lack of control and lack of marketability. Discounts typically range from 25% to 45%. But these valuation discounts can expose FLPs to increased risk of IRS challenge.

The IRS may also attack gift tax discounts by arguing that the donor of the gift is retaining an interest until death. If the partnership is operated as a "personal checkbook," the donor doesn't retain sufficient assets to live on and legal formalities are not all strictly observed, an FLP may be vulnerable.

But while the IRS has enjoyed some success in challenging discounts, a well-drafted FLP that holds assets valued by an independent valuator and is properly operated should be able to withstand attack. Following these guidelines may help your FLP stay in the IRS's good graces:

- Establish a business purpose for creating the FLP, and ideally transfer something that requires some active management, such as real estate.
- Observe all the formalities: Sign and file all documents and physically transfer all assets.
- Don't transfer anywhere near everything you own into the partnership; maintain some substantial separate assets outside the FLP.
- Consider letting one or more of your FLP's junior partners become a general partner.
- Don't use any real estate held by the FLP without paying rent.

Finally, income shouldn't be fully distributed to partners every year.

A flexible tool

There are several variations on the FLP concept. You may make large outright gifts all at once or spread them over a long period of time. You may want to set up trusts to act as limited partners, rather than individuals. Or you may choose to "freeze" your interest, receiving a specified return on your investment while other owners — typically younger family members — enjoy the appreciation on the partnership assets.

The FLP can form the centerpiece of your wealth management and estate plan. But because FLPs are so complex, a team of tax and legal professionals is essential to help you organize and implement one. ■

Donating a conservation easement to charity

Keep and preserve your property but get a tax deduction, too

You may have considered contributing real estate to charity to obtain an income tax deduction based on its fair market value. But you may not know that, in the right circumstances, it's also possible to contribute a "partial interest" in real estate to a charitable organization in the form of an easement while you and your family continue to own and use the property.

You would still receive a substantial income tax deduction, though it would only be for a small portion of the total value of the property. Such transfers, however, have the potential to abuse tax law, and IRS eyes are wide open to just such potential.

Qualifying property

Generally, property with an environmental or historical value can qualify for a conservation easement. This property may be your principal residence, vacation home, or investment or rental property. Examples include:

- Farmland or forestland that's a natural habitat for fish, wildlife, plants or other ecosystems,
- Lakefront property that includes a vacation home, or
- The façade of a building in an urban area that is part of a certified historic district or has historic value of its own.

In all of these examples, you may continue to use the property. But you must agree that you and your successor-owners in perpetuity won't develop or alter the property and will protect its natural use or historical value.

Protecting your donation

To help ensure your deduction withstands IRS scrutiny, you need to follow easement contribution rules carefully. The contribution must be made to a charitable organization with a purpose related to the easement on your property — for example, a nature conservancy or historical preservation society. Other organizations, such as religious or educational institutions, even though they are "qualified charitable organizations," won't qualify in this case.

Organizations that accept such contributions often require a cash contribution to accompany them, giving them the means to cover legal and administrative costs associated with owning the easement. Sometimes this cash requirement is tied to the value of the easement being contributed, and in any case it will also be tax-deductible as a charitable contribution.

You must agree that you and your successor-owners in perpetuity won't develop or alter the property.

The contribution also must be exclusively for conservation purposes. Courts have found this test to be met only when the charitable organization is not allowed to transfer its rights in the property and has agreed to enforce development restrictions.

Valuing the contribution

Even if these tests are met, valuing and thus determining the income tax deduction for the easement can be challenging. The deduction is equal to the fair market value donated to charity. This is measured by the difference in fair market value of the property as a whole, with and without the restriction on its use.

Say, for example, your 100 acres of farmland is valued at $5,000 per acre because its "highest and best use" is as development property for the building of single-family homes due to its proximity to existing residential development. But once the property is permanently restricted to use as farmland, its value is only $2,000 per acre. The difference of $3,000 per acre, or $300,000 for the property, can be considered the value of the contribution.

The gift for you?

The contribution of an easement can create a substantial deduction. If you own a property that qualifies and would consider a contribution that might restrict future development, it may be an excellent opportunity. ■

Cash on hand

Investing in short-term securities

Until recently, yields on cash investments — or very short-term securities — were paltry. They have since risen to respectable levels, however, following a steady stream of Federal Reserve interest rate hikes. This comes as good news to savers, as well as those living on a fixed income, because it provides an attractive alternative to longer-term bonds, whose yields have remained historically low.

If you're looking for a place to keep your rainy day funds, you may choose from one of three main options.

Money markets

Money market accounts and their close relative, money market mutual funds, are often used as higher-yield alternatives to an interest-bearing checking account. Both the accounts and funds generally offer check-writing privileges and considerable flexibility to withdraw funds.

You can open a money market account at most banks and other financial institutions, while you can find money market funds from mutual fund companies and other financial-services providers.

Money market funds themselves come in two varieties: taxable and tax-exempt. While both types invest in higher-quality, short-term securities, tax-exempt money funds purchase municipal bonds — which are exempt from federal income tax. Because of their tax-advantaged status, tax-exempt funds generally offer lower yields than their taxable counterparts. Their after-tax yields, however, are often (but not always) similar if you are near the highest tax brackets.

Note that some tax-exempt funds may subject you to the very complicated alternative minimum tax (AMT), so you should talk with your tax or investment advisor before buying tax-exempt securities. Also keep in mind that tax-exempt money market funds are not usually appropriate for retirement accounts that are already tax-advantaged.

Certificates of deposit

With a certificate of deposit (CD), you agree to lend money to a bank or other financial institution for a fixed period of time in exchange for a set level of interest. If you remove your funds before the CD term ends, you'll be charged an early withdrawal penalty.

CD yields are fixed, meaning you'll continue to earn the same income no matter how interest rates move during the term of the CD. In contrast, money market account and money market fund yields tend to fluctuate with short-term interest rates.

Do you like guarantees?

Both CDs and money market accounts are Federal Deposit Insurance Corporation (FDIC) insured, guaranteeing up to $100,000 per deposit per institution. This makes them somewhat safer than money market funds, which do not provide FDIC protection. Money market funds generally offer somewhat higher yields to compensate for this lack of insurance.

Historically, however, the risk to savings in a money market fund has been lower than the risk associated with investing in other types of mutual funds. Investment companies are unlikely to allow your share price to dip below the $1 level where funds typically remain. And if unexpected market losses were to occur, the fund would often make up any shortfall. Nevertheless, there's no guarantee it will do so.

Calculating after-tax yields

Say you're choosing between a taxable money market fund offering a yield of 4% and a tax-exempt fund yielding 2.75%. You're in the 30% federal income tax bracket. Which option will produce better returns?

Just divide the tax-exempt yield by 1 minus your tax rate:

$$2.75\% / (1 - 0.30) = 3.93\%$$

In this case, you would do slightly better after taxes with the taxable fund. But because the yield relationships between the two types of funds fluctuate along with market conditions, you may find that the best option today isn't the most attractive six months from now.

Consider your time frame

When deciding which investment vehicle is best for your situation, consider how you plan to use your money. If you expect to need access to your savings in the near future — say, for a down payment on a home — you may be better off with the flexibility of a money market product.

If, however, you're saving for a specific financial goal that's several years away, or you're on a fixed income and simply looking to preserve your capital, flexibility may not be as important as the guaranteed, usually higher, fixed rate offered by a CD.

Each investment type has its place, but all three have one important quality in common: They let you earn a respectable yield without keeping you up at night. ■

When — and when not — to pay down your mortgage

You probably know that, when you increase the size of your monthly mortgage payments, you can save a significant amount of money over the life of your loan. For example, paying an additional $50 monthly on a 30-year, $300,000 mortgage at 6% will cut your total interest costs by more than $38,000. But does it always make sense to pay down your mortgage?

Some guidelines

Generally, it's a smart move to pay down your mortgage if you're unlikely to earn an investment return that exceeds your interest rate.

Younger investors may have less of an incentive to apply their savings to additional mortgage payments. Because of their longer time horizon, they can probably afford to take advantage of the stock market's higher return potential, and therefore have an expectation of outperforming the interest rate on the mortgage. Nevertheless, paying off a mortgage can be a safer route because, while there's no guarantee your investments will perform well, you are always responsible for mortgage payments.

Investors nearing retirement and whose portfolios include lower-yielding bonds may find it more difficult to outearn their borrowing costs. Paying down their mortgage balance, therefore, is more attractive. One exception might be if your alternative is to invest in a tax-advantaged retirement account such as a 401(k) plan — particularly if you receive matching funds from your employer.

Other financial considerations

As you decide whether to pay down your mortgage, be sure not to shortchange other important financial needs, such as purchasing sufficient insurance and maintaining an emergency fund. If you have any high-interest-rate debts — such as credit card balances — paying those off should be your first priority.

Your source for customized investment and financial planning

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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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We provide a full range of investment consulting and financial planning services including:

- Investment Policy Review/Creation
- Comprehensive Personal Financial Planning
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- Fund Cost Efficiency Analysis
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