



Financial Foresights

Practical Insights For Your Financial Goals

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Hi Everyone!

I hope you enjoy this month's edition of my newsletter. Have a happy Halloween!

Dave

In this issue:

"Kiddie Tax" Rules: The College Years

Absolute Return Investing:
Aiming for Market
Independence

Do You Need More Liability
Protection?

Ask the Experts

"Kiddie Tax" Rules: The College Years



Special rules can apply when your child has unearned income. These "kiddie tax" rules may tax a portion of your child's unearned income at

your (presumably higher) marginal tax rate. Legislation signed into law in May expands the potential reach of the kiddie tax rules to college-aged children, prompting many parents to rethink gifting strategies.

Kiddie tax basics

Generally, the kiddie tax rules apply when a child has unearned income exceeding \$1,700 (2007 figure). What's unearned income? It's income other than wages, salary, professional fees, or any other compensation for services. Interest and investment earnings are considered unearned income, as is taxable gain that results from the sale of an asset.

Prior to the Small Business and Work Opportunity Tax Act of 2007, the kiddie tax rules applied to children under the age of 18. Beginning in 2008, however, the new legislation expands the kiddie tax rules to apply to children who are under age 19, and to full-time students under age 24. There's an exception carved out for any child who earns more than one-half of his or her own support.

Deja vu

This is the second time in two years that the kiddie tax rules have been expanded. Last year's Tax Increase Prevention and Reconciliation Act raised the applicable kiddie tax age from under age 14 to under age 18.

Why the change?

The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the tax rate on long-term capital gains and qualifying dividends.

Specifically, the act established a 15% tax rate for individuals in the higher tax brackets and a 5% rate for individuals in the bottom two tax brackets. Even more significant is that, beginning in 2008, the tax rate on long-term capital gains and qualifying dividends drops to zero for individuals in the lowest two tax brackets (this zero tax rate remains effective for tax years through 2010).

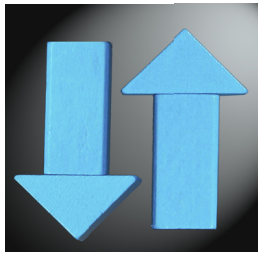
The zero tax rate applicable to individuals in the lower tax brackets presented a real planning opportunity: transfer appreciated investment assets to your child attending college. Since your child would likely be in the lower two tax brackets, he or she could then sell the assets in the year he or she turned 18, and use the resulting proceeds--tax free--to pay college expenses.

Impact of the new legislation

By expanding the kiddie tax rules to include full-time students under age 24, the Small Business and Work Opportunity Tax Act of 2007 eliminates or greatly limits this planning opportunity for most families. Starting next year, if your child is a full-time student (who does not earn more than one-half of his or her own support), the kiddie tax rules will kick in if your child sells an investment asset before the year in which he or she reaches age 24. The resulting income--at least the portion that exceeds \$1,700 with an adjustment for inflation--will be taxed at your (presumably higher) tax rate, eliminating most or all of any potential tax savings.

A final word

The new rules aren't effective until 2008 for most people. So, if you've already transferred investments to a child, or intend to do so, you have a limited window to operate under the old rules. If you have questions, be sure to discuss your situation with a tax professional before the end of the year.



Market risk: part of the class system

Any investment involves some type of risk. Even U.S.

Treasury bonds, considered relatively safe, involve market risk, because they can be affected by the behavior of the overall bond market.

Market risk, also known as systematic risk, is common to an entire type of investment. You can't wipe out the market risk of your stock portfolio by simply buying other stocks. Even diversifying by investing in other asset classes doesn't completely dispense with market risk, because each asset class involves its own type of market risk.

Absolute Return Investing: Aiming for Market Independence

Wouldn't it be great if you could reduce your portfolio's risk by some means other than simply reducing or eliminating your investments in highly volatile asset classes? Well, that's the goal of absolute return investing. However, as with all investments, there's a tradeoff. To try to reduce market risk, you'll probably increase your exposure to other types of risk.

Benchmarks and absolute return

An investment typically is gauged relative to its benchmark's performance. For example, a negative return might still be considered successful if the loss was less than that of the benchmark to which it is compared. And an investment might have positive returns simply because its asset class is doing well.

By contrast, absolute return, or market-neutral, strategies attempt to make money each year--or at least not lose it--no matter what's happening with the market. An absolute return portfolio's performance benchmark might be the risk-free return on cash. For example, a manager might aim for a return equal to that of a short-term bank deposit plus three or four percentage points. (Of course, as with any investment, there's no guarantee that it will achieve its goal.)

The long and short of investing

Many absolute return investments attempt to eliminate market risk--that is, be market-neutral--by adopting so-called long-short strategies, which rely on the difference between being "long" and selling short. Short selling involves borrowing shares or other securities and selling them, in the belief that the price will drop and you will be able to buy them for less when you must replace them later. The difference between the price you got when you sold the shares and the price you paid to replace them is your profit. However, you also can lose money if the price rises and you must pay more to replace the borrowed shares than you got for them.

A short sale is bearish. By contrast, being long--buying a security outright--is a bullish position; if you think an investment will decrease in value, you probably won't buy it.

Trying to have it both ways

Market-neutral strategies try to have the best of both worlds by investing in both long and short positions, typically in equal proportion. For example, a manager might buy a security he or she considers undervalued, and sell

short an equal dollar amount of a similar security that appears overvalued. The opposing long and short positions are designed to neutralize the ups and downs of that particular market--hence the name--and reduce a portfolio's volatility. Because it strives to be independent of market behavior, a market-neutral portfolio's performance is based almost exclusively on its manager's ability to identify and trade under- and overvalued securities.

But wait--isn't that exactly what an actively managed mutual fund does? Yes, but the typical mutual fund manager who's concerned about a particular security or sector either invests less in it or avoids it. A market-neutral manager might actually short that sector or security, actively attempting to take advantage of its problems. In some ways, a market-neutral fund is the mirror image of an index mutual fund. Because an index fund is designed to replicate a particular market, it is 100% exposed to market risk; a market-neutral portfolio takes the opposite approach.

If it's not one thing, it's another

Of course, even if a portfolio manages to be independent of market risk, that doesn't mean it's eliminated other risks. A market-neutral portfolio's manager can misjudge which securities to buy or short, or the timing of those trades; also, there are specific risks associated with each individual security. Any of the above can have as unexpected and dramatic an impact as overall market movements. Though absolute return investing attempts to lower volatility and achieve a positive return, there are no guarantees it will do so, and it may not be appropriate for all investors.

Seeking absolute return

Hedge funds and institutional investors often rely on absolute return investing. However, in recent years, mutual funds with similar strategies have expanded the concept to a broader range of investors. A fund may focus on a single asset class, or include multiple asset classes as well as global investments.

If you're considering an absolute return fund, you'll need to pay attention to costs; a greater level of complexity can increase trading expenses. Consider also how a given strategy has fared in both up and down markets. Consult a financial professional to see if absolute return investing makes sense for part of your portfolio.

Do You Need More Liability Protection?

Liability insurance protects individuals and businesses in the event they're held financially responsible for injuring someone or causing property damage. You probably already have this important protection, but do you have enough?

Personal liability insurance

Despite the common belief that only people with substantial wealth or assets are the targets of lawsuits, that's not necessarily the case. Accidents can happen anywhere, to anyone, and even people of modest means may be at risk. For example, here are some common situations that might result in a liability claim:

- Your dog escapes from the house and bites a delivery person
- A neighbor's child is hurt while jumping on your backyard trampoline
- Your vehicle broadsides another, injuring the driver

Unfortunately, if you're sued, your assets are potentially at stake—your savings, your investments, and in most states, even your home. Even if the claim is eventually proved groundless and you're not held liable for damages, the cost of mounting a defense can be high.

That's why personal liability insurance is so important. Not only does it cover any court awards you're required to pay as a result of damage or injury caused by you, your family members, or your pets, but it also covers your legal bills, up to policy limits.

You probably already have some coverage

Homeowners, renters, and auto policies all contain liability coverage, so you may already have a basic layer of protection. However, you may not have enough, especially if you have only the minimum required. For example, liability limits for homeowners insurance generally start at \$100,000, while required minimum limits for auto insurance in most states range from \$30,000 to \$60,000. Often, you'll need far more liability coverage than this to adequately protect your assets.

Ask an insurance professional to review your liability limits and help you decide how much you need, based on factors such as your age, assets, income, and lifestyle.

If you need more coverage

What if you have the highest available

coverage limits but you still need an additional layer of protection? Consider purchasing an excess liability policy, also called an umbrella liability policy. Because it offers higher coverage limits (often starting at \$1 million) than basic personal liability insurance, an umbrella policy will cover you for larger losses.

You'll need to have a certain level of underlying liability coverage (generally between \$100,000 and \$500,000) in order to purchase an umbrella liability policy, because the umbrella coverage kicks in only after you've reached the limits of your underlying policy. For example, if you have an auto policy with a liability limit of \$300,000 per accident and a \$1 million umbrella policy, your auto policy would cover the first \$300,000 of a \$700,000 claim and your umbrella policy would cover the remaining \$400,000.

Business and professional liability insurance

The widely publicized case of a dry-cleaning business that was sued for \$54 million over a lost pair of pants illustrates the importance of business liability protection. Although the owners of the business prevailed in the lawsuit and were awarded court costs (not including attorney's fees), they did not have liability coverage, and they may never recover the tens of thousands of dollars they spent mounting a two-year defense against this lawsuit.

While businesses can't always prevent such liability claims, they can purchase coverage for the special risks they face. One option is commercial general liability insurance, which is often part of a business owners policy. Business umbrella liability policies that offer higher liability limits are also available.

However, some liability risks are unique to certain businesses or professions, so you may also need specialized coverage. For example, if you work in an occupation that is particularly vulnerable to professional liability (e.g., law, medicine, day care), you may also need a separate professional liability policy, usually called malpractice coverage or errors and omissions coverage. Many other types of specialized liability coverage are also available.

Talk to an insurance professional who can help you determine the types and amounts of liability coverage that are appropriate for your business or profession.

Read your policy carefully to find out what's covered and what's not, and to learn about your rights and responsibilities.



Review your liability insurance limits periodically to make sure your coverage keeps pace with your needs.



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Ask the Experts



What's a self-directed IRA?

A self-directed IRA isn't a different type of IRA. Rather, the term refers to any individual retirement account (traditional or Roth)

that gives you more investment control by allowing you to direct your IRA assets into nontraditional investments.

For example, in addition to the usual IRA mainstays (stocks, bonds, mutual funds, and CDs), a self-directed IRA might invest in real estate, options, limited partnership interests, or anything else the law (and your IRA trustee/custodian) allows. In fact, the only investment you *can't* have in an IRA is life insurance. (Collectibles--for example, artwork, stamps, wine, and antiques--aren't prohibited, but if your IRA purchases these items, you could suffer adverse tax consequences.)

To get started, you'll need to find a trustee or custodian that specializes in self-directed IRAs. Make sure you understand the expenses involved--some trustees charge transaction fees and/or asset-based fees,

depending on the particular investment.

You also need to be aware of the prohibited transaction rules. These rules are designed to make sure that only your IRA, and not you (or your immediate family), benefits from your IRA transactions. For example, you are prohibited from buying investments from, or selling investments to, your IRA. If you violate these rules, your account will cease to be treated as an IRA, with potentially devastating tax consequences.

Finally, you need to understand the UBIT (unrelated business income tax) rules. Even though IRA investments usually grow tax deferred (or even potentially tax free in the case of a Roth IRA), if your IRA conducts certain business activities, or has debt-financed income, then your IRA could be taxed currently on all or part of the income generated.

Your financial professional can help you weigh the benefits and risks of a self-directed IRA, and help you determine if it's the right choice for you.

Can my self-directed IRA invest in real estate?

Yes. Your IRA can invest in virtually any form of real estate. That includes direct ownership in property as well as indirect ownership through limited partnership interests, REITs, and mortgage obligations. Your IRA can buy a beach house, a multi-family home, commercial property, raw land, time shares, condos, an island--almost anything. Your IRA can be the sole owner of the real estate, or a partial owner with others.

Your IRA can even borrow money to purchase real estate. However, it may be difficult to find a bank that will lend money to your IRA (since you can't personally guarantee the note). Borrowing may also cause some of the income (or sales proceeds) from the property to be taxed currently to your IRA under the UBIT (unrelated business income tax) rules.

When you invest in real estate you'll also need to pay particular attention to the prohibited transaction rules. You can't, for example, sell property you already own to your IRA. And neither you nor certain family members can

use real estate while it's owned by your IRA. That sort of self-dealing can result in your entire IRA becoming taxable to you.

Keep in mind that when you hold real estate in a traditional IRA, you'll have to pay tax at ordinary income rates when your account is ultimately paid out to you--whether you receive cash or the property itself.

Qualified distributions from a self-directed Roth IRA, on the other hand, are free from federal income tax, which makes the Roth IRA an attractive vehicle for real estate ownership. Say you've found your dream retirement home. You could have your Roth IRA purchase the property, rent it out to generate income, and then, when you're ready to retire, have the IRA distribute the property (and any income) to you tax free.

Finally, note that you'll need to pay any expenses related to your real estate investment out of your IRA, so make sure it will have enough cash each year to cover any real estate taxes, legal fees, repairs, insurance, and other costs.