

# Options



Winter 2011

## A Closer Look at Your Risk Tolerance

What type of investor are you? Aggressive and risk tolerant? Conservative and risk averse? Or somewhere in the middle? Your ability to tolerate risk influences the investment choices you make — and, ultimately, may have an impact on your success at reaching your financial goals.

### Risk Tolerance Isn't Static

Ongoing market volatility can affect an investor's risk tolerance. During an extended period of extreme market fluctuations, investors who previously had a high capacity for risk may find their comfort levels dropping. Similarly, prolonged market upswings may encourage previously conservative investors to invest more heavily in the market. As a result, they take on additional investment risk.

### Capacity Is Another Component

Your ability to accept risk also depends on financial and other considerations, such as your time horizon for tapping your assets. Consider how much money you could afford to lose if investment values dropped appreciably. If investment losses would undermine your financial

security, and you have a short time frame until you'll need your funds, your *capacity* to take risk may be limited.

### Perform a Reality Check

A long stretch of either strong or weak market performance can convince investors that the current trend will continue indefinitely. *Perceived* risk — how much risk you *think* an investment holds — is a subjective gauge. Thus, your *perception* of an investment's risk might not be in sync with its *actual* risk. Because your risk tolerance may change over time, consider revisiting the subject periodically — ideally during your annual investment performance review.

Your financial professional can help you reassess your risk tolerance and the level of risk in your portfolio.

## A Cautious Approach

Municipal bonds (munis) historically have had a lower default rate than corporate bonds. But the economy of the past several years has made the safety and security of munis more vulnerable.

Munis are issued by state and local governments to fund projects such as building or improving schools, highways, and infrastructure. But budget issues can force communities to suspend public projects — which may lower bond values — so investors should use caution.

Larger cities typically are more stable than smaller communities during tough economic times. So investment-grade bonds of large and liquid issuers may offer more security with less risk. Essential service revenue bonds, such as those that fund water, sewer, and utility projects, may be less affected by a downturn.

Investing in bonds from various issuers can provide diversification and exposure to a variety of economic situations. If you invest in munis, make sure your portfolio is regularly reviewed, since bond credit ratings can change over time.

## Margin Accounts — Worth Their Risks?

Buying on margin is an arrangement that allows you to borrow money from your broker to buy securities using your investments' value as collateral. Using margin lets you buy more stock without having to fully pay for it up front. If the value of the margined securities increases, you'll likely earn

enough to pay back the loan with interest and reap a profit. But, if their value drops, you may face difficulties.

To open a margin account, you deposit a portion of the purchase price of the securities you want to buy — called the margin — with the brokerage firm. You'll be required to keep a minimum level of equity in your account.

If the equity in your account falls below the required minimum, the brokerage will issue a "margin call," and you'll have to either deposit cash or additional securities or sell some of your securities. If you don't "meet" the margin call, the firm will sell securities in your account to satisfy the margin requirement.

Buying on margin can be risky. Make sure you're comfortable with the risks before you pursue this strategy.



### Managing Margin Risk

Margin trading involves greater risk than trading on a cash basis in an account where margin isn't used. The following suggestions may help you manage margin account risk.

- Familiarize yourself with margin requirement risks and rules.
- Monitor your account closely.
- Consider the volatility of the securities you plan on using as collateral for your loan.
- Consider your own risk tolerance before you engage in margin trading.
- Limit leverage and have enough cash on hand to cover a potential margin call so you won't be forced to sell securities when values are down.

## Donating Property? You May Need an Appraisal

If you wish to donate noncash property valued at more than \$5,000 to a charitable organization, you'll generally have to obtain a qualified appraisal that meets IRS guidelines. An appraiser typically will use an item's fair market value (FMV) as the basis for valuation. FMV is the price the property would sell for on the open market given a willing buyer and a willing seller, no compulsion to buy or sell, and reasonable knowledge of the relevant facts.

You'll be responsible for providing the IRS with information that supports your right to deduct the charitable contribution. In most cases, this will be an "appraisal summary" on an IRS form attached to your tax return. You'll have to attach a copy of the

appraisal for gifts of art valued at \$20,000 or more and for all gifts of property valued at more than \$500,000, not including inventory, publicly traded stock, and intellectual property.

If you make gifts of two or more items in the same tax year — whether to one or multiple donees — the values of all

property in the same category should be added together to determine if the \$5,000 limit is exceeded.

The appraisal must be received before your income-tax return is due. It must be signed, dated, and made no earlier than 60 days before you donate the appraised property.

### Qualified Appraisal Requirement: The Exceptions

Certain contributions don't require a qualified appraisal. These include:

- A car, boat, or airplane for which the deduction is limited to the charity's gross proceeds on the property's sale
- Stock in trade, inventory, or property held primarily for sale to customers in the regular course of business
- Publicly traded securities for which market quotations are readily available
- Qualified intellectual property, such as a patent

## Diversification and — Taxes?

You may think of diversification exclusively as an investing tool. But diversification can play an important role in tax planning.

“Tax diversification” provides investors with a strategy designed to counteract uncertainties surrounding future tax rates. It involves allocating your investments among a variety of accounts that are subject to different tax treatments.

By placing appropriate investments in each account and following a carefully planned withdrawal strategy, you’ll have more flexibility to potentially maximize your after-tax returns even if the tax landscape shifts in the future.



### What Goes Where?

Choosing which investments to hold in taxable and tax-favored accounts is the first step in the process of boosting returns. Consider holding actively traded stocks and stock funds in a Roth individual retirement account (IRA) to benefit from a Roth’s tax-deferred growth and potentially tax-free treatment upon withdrawal.

Tax-exempt investments, such as municipal bonds and bond funds, are a good choice for taxable accounts, while taxable bonds and bond funds generally should be earmarked for tax-deferred accounts, such as a traditional IRA or 401(k).



### Your Withdrawal Strategy

Having a strategy for tapping your accounts during retirement may save you a substantial amount in taxes. Consider withdrawing money from a taxable brokerage account until you reach age 70½, when you’ll be required to start taking annual distributions from tax-deferred retirement accounts. Liquidating unappreciated securities first would avoid capital gains tax, letting you keep more of your money.

Withdrawals from a traditional IRA, 401(k), or similar plan account generally are taxed as ordinary income, which may propel you into a higher tax bracket. Taking only your required minimum distribution from these accounts and taking qualified tax-free withdrawals from a Roth IRA to cover the remaining amount you’ll need for living expenses may keep you in a lower tax bracket.

Careful tax planning can help you maximize your investment returns.



## New Rules for Reporting Basis

If you’ve ever spent hours trying to determine your cost basis in a stock you’ve sold, the IRS has good news. Under new tax rules, stock brokers and mutual fund companies will be required to report cost basis information on most securities sales to investors and the IRS. That means you’ll have it a lot easier when it comes to figuring out and reporting gain or loss realized on your transactions.

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The new reporting rules apply to most stock acquired on or after January 1, 2011 (January 1, 2012, for mutual fund shares and stock acquired in connection with a dividend reinvestment plan). Additional securities will come under the new rules beginning January 1, 2013.

The basis information will be reported on an expanded Form 1099-B. The form will also show whether the gain or loss realized qualifies as short or long term. You can check for accuracy by comparing your purchase and sale documentation with the transaction information that’s being reported to the IRS — and to you — by your institution.

# Giftting Property with a QPRT



The return of the estate tax\* lends new urgency to a number of estate planning issues. Taking measures to minimize potential estate taxes should again be one of your priorities.

Establishing a trust may be an effective strategy for removing assets from your estate and preserving more of your wealth for your heirs.

A *qualified personal residence trust* (QPRT) is one arrangement you may want to consider. A QPRT allows you to gift property to your children or other beneficiaries by transferring your house or vacation home into an irrevocable trust. For a set period of time — the trust term — you can continue to live in your house or use your vacation home rent free. You'll be responsible

for paying property taxes, mortgage expenses, insurance, and maintenance costs. And you'll still be entitled to deduct mortgage interest and real estate taxes on your income-tax return.

## Reducing the Gift's Value

The transfer of your residence to the trust is a taxable gift. However, you're allowed to subtract the value of your right to live rent free for the trust term from the fair market value of the residence. Therefore, the amount of the taxable gift typically will be substantially less than the fair market value of your home. And your lifetime gift-tax exemption, if available, may be applied to the gift, reducing or eliminating your gift-tax liability.

## Tax Consequences

As long as you outlive the trust's term, the property's value won't be included in your estate for federal estate-tax purposes. However, if you don't outlive the trust term, the property will remain in your estate, and the estate-tax consequences will be the same as they would have been if you hadn't created the trust.

## Looking Ahead

If you want to remain in your home when the fixed term ends, you can lease the home from your beneficiary and pay fair market rent to avoid disqualifying the original arrangement.

We can further explain the role a QPRT might play in your estate planning strategy. Call us.

\* At press time, Congress is in the midst of considering legislation addressing the "sunset" of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). That law repealed the estate tax for 2010 only. Expectations are that the estate tax will return in 2011, but specific provisions are as yet undetermined.

*This publication involves sophisticated tax and financial planning concepts. Before applying anything you read to your situation, you should consult with your professional advisor.*

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