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Financial Regulation Reform Battle Begins

by John Slayton, JD/MBA, LLM-TAX, CFP®, AEP, CTFA

In the midst of the heated debate over health care reform this summer, you may have missed the Obama Administration unveiling its much-anticipated *Plan for Restructuring Financial Services Regulation* on June 17, 2009 (the "Plan"). The resulting flurry of legislative submissions and hearings evidences that, rather than a comprehensive restructuring, the Plan aims instead to fill regulatory gaps by granting new powers to existing regulators and, not surprisingly, creating new regulators. In summary, the Plan would:

>> **Grant the Federal Reserve supervisory power** over all large financial institutions that pose systemic risk, requiring heightened capital, liquidity and risk management standards.

>> **Merge the Office of Thrift Supervision into the Comptroller of the Currency.**

>> **Keep the CFTC and SEC separate**, but harmonize regulation of futures and regulate over-the-counter traded derivatives.

>> **Create a new Financial Services Oversight Council** made up of most of the financial regulators, to assist the Fed.

>> **Create a new and independent Consumer Financial Protection Agency** (CFPA), to regulate all financial products, services and providers.

>> **Create a new Office of National Insurance**, within Treasury, to coordinate policies, but not to replace any of the 50 state insurance regulators.

>> **Require advisors to hedge funds and private equity firms to register with the SEC** and impose recordkeeping, disclosure and reporting requirements on such funds.

>> **Establish a fiduciary duty for broker-dealers offering investment advice**, akin to registered investment advisors.

>> **Require loan originators to retain a 5% interest in loans to be sold** ("skin in the game") and regulate issuers of asset-backed securities.

The breadth of agencies impacted by the Plan has resulted in a predictable "turf-war" between regulators fearing loss of power. Treasury Secretary Geithner has even had to

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NOTABLE QUOTE

"The difference between luck and skill is seldom apparent at first glance."
– Peter Bernstein

Trust Company of the South...because wealth management is more than managing money

regulate the regulators, when he "reportedly" launched into an all-out cussing tirade during a meeting with the Chairs of the Fed, SEC and FDIC, admonishing them to stay on message with the President's proposals. What parts of the Plan could cause senior regulators to behave as if they were participants in a health care reform town hall meeting?

The Plan proposes a new consumer agency, the CFPA, with broad supervisory and enforcement authority over virtually all financial products and services, ranging from requiring mortgage companies to offer a straightforward "plain vanilla" mortgage product, to requiring reasonableness in communications and transparency in mortgage loan disclosures. Banking agencies responsible for consumer protection arguably have different priorities-- the safety and soundness of the institutions they oversee. Their mission focuses more on the effect of a bank's products and services on the bank itself, rather than their effect on consumers. In contrast, the CFPA would be the ultimate authority for consumer protection.

Systemic risk was abruptly rediscovered last fall, when the global financial structure nearly imploded. The Plan proposes granting the Fed the power to supervise all large financial institutions that pose systemic risk, whether they own banks or not. These large interconnected firms (Tier 1 financial holding companies) would be subject to heightened capital, liquidity and risk management standards. The Fed would be advised by a new Financial Services Oversight Council, made up of the other senior financial regulators. Arguably, the Fed (with the Treasury Secretary) has been serving this function throughout this recent financial crisis. Lately, however, some legislators have questioned the actions of the Fed in negotiating solutions to the crisis. The Fed was established in 1913 as an independent central bank, primarily responsible for stable prices, full employment and sustainable economic growth. Independence is needed to make the politically unpopular interest rate decisions necessary to battle inflation and unemployment. If the Fed becomes the "super-cop" against systemic risk, we must be careful that Congress does not politicize monetary policy through oversight of the Fed's new proposed duties. A single, strong, independent agency (preferably the Fed) with able leadership, broad authority and the advice of the Financial Oversight Council should be our best defense against systemic risk.

The Plan contemplates maintaining the SEC and the CFTC as separate entities, but requires more consistent regulation of commodities, futures and derivatives. All standardized derivatives traded "over-the-counter," including credit default swaps, would be subjected to comprehensive regulation. The Office of Thrift Supervision would be merged into the Comptroller of the Currency, removing the federal thrift charter and consolidating regulation. After intense debate regarding weakness in insurance regulation at the state level, the Plan proposes an Office of National Insurance within the Treasury Department, to gather and disseminate information, but not to replace any of the 50 state insurance regulators. Any efforts at streamlining and updating our financial regulation should be applauded and not derailed by typical turf protecting tactics.

In the investment management arena, the Plan recommends that all advisors to hedge and private equity funds register with the SEC as investment advisors. The Plan also establishes a fiduciary duty for broker-dealers offering investment advice, consistent with the duty of registered investment advisors. A fiduciary must always put the client's interests ahead of the adviser's. Holding all investment professionals to a consistent fiduciary standard would correct many conflicts of interest and past abuses and be a huge benefit to the investing public.

Pooling of sub-prime mortgages and selling pieces of the pools to investors, known as securitization, has been blamed for much of the recent financial havoc. The Plan strives to regulate the securitization markets in order to improve transparency and market discipline of originators, underwriters and credit rating agencies, requiring loan originators to retain five percent of the loans to be securitized.

The fate of the Administration's Plan on Capitol Hill is uncertain. Will it be lost in the health care reform morass? Hopefully not. The Plan provides effective solutions to glaring regulatory shortcomings that resulted in our worst financial crisis since the Great Depression. It is crucial that these failures be cured before the economy recovers and we forget the causes of such huge global destruction of wealth. To be informed is to be empowered.

Year-End Tax Planning

by Chris Sutherland, CPA®

In the last decade Congress has passed numerous new tax laws. Most of these changes have been favorable to both individuals and corporations. That trend is almost certain to reverse in the coming year. Unless Congress takes action, most of the tax reductions created by the 2001 legislation will expire in 2011; the highest individual income tax bracket will jump back to 39.6% from 35%, qualified dividends will be taxed as ordinary income (potentially 39.6% rather than 15%), and the long term capital gains rate will revert to 20% from 15%.

Doing nothing does not appear to be an option Congress is contemplating. There are several proposals on the table. The most onerous not only involve increases in rates, but also a surtax on wealthy taxpayers.

With changes likely, what should you consider now to reduce your tax bill?

>> **Accelerate income** – In most years, taxpayers look for ways to defer income, thereby deferring tax liability. That may not be in your best interest this year. Taxpayers in the highest bracket could see as much as a 15% increase in their marginal federal rate next year. If you expect to be in the top bracket next year, it might make sense to accelerate income.

>> **Defer Deductions** – For the same reason stated above, consider deferring deductions to next year. Instead of paying your property tax bill at the end of the year, consider paying the tab in January.

>> **Alternative Minimum Tax (AMT)** – AMT has been a thorn in the side of taxpayers for years. For the last several years Congress has enacted one-year "patches" to prevent millions more taxpayers from being subject to AMT.

One of the easiest ways to minimize AMT is by timing your state, real estate and property tax payments. These itemized deductions are not deductible under the AMT system; if you are subject to AMT, you are losing these deductions. In past years, deferring state and property tax payments did little to reduce overall tax liability, but if ordinary rates rise, those deductions could be valuable in 2010.

Another item that affects AMT is interest income from private activity bonds. This interest is not subject to ordinary tax but is subject to AMT. *New this year: Any private activity bond issued in 2009 or 2010 is not subject to AMT.* This treatment does not apply to bonds issued before 2009.

There are other income and deduction items that affect AMT (miscellaneous itemized deductions and medical expenses, for example). Be aware of these as you review your tax situation before the end of the year.

>> **Capital Losses** –You can deduct up to $3,000 of net capital losses against ordinary income each year. Consider maximizing your realized losses this year. Any net loss above the $3,000 is carried forward. With a likely increase in long term capital gains rates on the horizon, those losses could be valuable as mutual funds produce capital gain distributions.

>> **Income Shifting** – Income shifting simply involves transferring income producing property to a family member in a lower tax bracket. For example, if a taxpayer in the top tax bracket transfers a corporate bond to a family member in the lowest tax bracket, it is possible to save as much as 25% on your tax bill. This strategy has pitfalls, however. You must be aware of not only gift tax issues, but also "kiddie" tax. Kiddie tax now applies to certain children as old as 23.

>> **Estate Tax** –There are at least four bills that have been introduced in Congress this year that address gift and estate tax. One of these or some compromise is almost certain to pass. Without a new bill, the estate tax is eliminated in 2010 for one year. The proposals under consideration include exemption amounts ranging from $2 million to $5 million. Odds have been favoring a $3.5 million final amount. All but one of the bills index the exemption to inflation and all four reunify the gift tax with the estate tax.

Reunification of the gift and estate tax is good news for taxpayers that have fully utilized their lifetime gift tax

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exemption. This will allow those taxpayers to make larger gifts during their lifetime, reducing estate tax due at death. Up until 2004 the gift and estate tax exemptions were the same. Beginning in 2004 when the estate tax exemption rose to $1.5 million, the gift tax exemption remained at $1 million and is still $1 million in 2009.

Another key component of pending legislation would reduce the use of valuation discounts. Over the past several years valuation discounts for minority interest and lack of control have been valued at up to 40%. This has provided significant leverage for taxpayers in making large gifts to family members.

The availability of valuation discounts along with very low interest rates offer a great environment for significant wealth transfers. But time is running out…valuation discounts may be severely limited soon and interest rates are not likely to drop further.

This year, maybe more than any in the last decade, provides opportunity for both income and estate tax planning that could not only save tax, but result in material wealth generation.

Latest Tax Data from IRS

TAX YEAR 2007

>> **Top 1% of filers paid 40.4% of federal income tax, up from 39.9% in 2006**

>> **Yet, those same taxpayers in top 1% made only 22.8% of reported AGI**

>> **Top 1% included those with AGI of $410,100**

>> **Top 5% (AGI of $160k) paid 60.6% of total tax**

>> **Top 10% (AGI of $113k) paid 71.2%**

>> **Bottom 50% of filers paid only 2.9% of total income tax collected!**

Behind the Scenes at Trust Company of the South

>> **Mike Palmer** attended the NAPFA Carolinas Chapter Study Group in Columbia, SC where he moderated a panel discussion on developing human capital within a financial planning firm.

>> **Jay Eich** is serving as chair of the 2010 Queens University Estate Planner's Day committee.

>> **John Slayton** is writing a series of columns for the *Burlington Times News* on current financial and regulatory issues.

>> **Mike Palmer** was quoted in the August issue of *Financial Advisor* magazine on the intricacies of Monte Carlo simulations in financial planning.

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