[the*compass*] summer 2008

THIS ISSUE...

May You Live in Interesting Times

by John H. Slayton, JD, CFP®, LLM-TAX

Whether this ancient oriental saying is a blessing or a curse is often debated, as is the condition of today's economy and securities markets. We have previously discussed the impact of the shadow banking system and the derivatives market. For our lazy summer day's amusement, let's consider the impact of a few of the other issues prevalent in today's news.

The Housing and Credit Crises.

I do not own stock in any banks or brokerage firms and I have paid off my mortgage, so why should I care?

We are gradually working our way through the sub-prime debt issues, with banks and securities firms taking huge write-offs and raising additional capital (often from Mid-eastern sovereign funds flush with oil proceeds). In recent years, homeowners took out hundreds of billions in home equity to finance their spending, or used 100% financing to acquire their houses at bubble prices, resulting in five consecutive quarters with homeowner equity below 50%. The tougher housing issue involves the widespread geographic decreases (well beyond Las Vegas, Miami and Phoenix) and their likely duration. The end of the "home equity ATM" will likely limit consumer spending for several years, which will slow overall economic growth (GDP), resulting in higher unemployment and weaker corporate earnings, which will lower stock market returns. Housing foreclosures depress prices in entire neighborhoods, impacting many more than the unfortunate borrowers, so it is important to put this normalization process behind us. The housing collapse perpetuates a nasty downward spiral that could result in …

Stagflation.

Speaking recently at Harvard, Fed Chairman Ben Bernanke focused on the impact of the weak dollar in the face of soaring energy, agricultural and commodity prices, comparing today's situation to that of the 1970s, when runaway inflation, high unemployment and

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NOTABLE QUOTE

"The investor's chief problem – and even his worst enemy – is likely to be himself."

- Benjamin Graham

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

Roth IRAs for the High Earners

by Jay D. Eich, CFP®, CPA and Christopher N. Sutherland, CPA

Many people are not contributing to their traditional IRAs because their income exceeds the amount for obtaining a deduction. In addition, similar income limits disqualify many individuals from contributing to Roth IRAs. In a normal tax year traditional IRAs can be converted to a Roth IRA only if income is less than $100,000. Beginning in 2010 that rule does not apply, providing everyone an opportunity to convert a traditional IRA to a Roth IRA.

While many people are prohibited from contributing to a deductible IRA or Roth IRA, most have the ability to contribute to a nondeductible IRA. Unlike a deductible IRA, you will not obtain a current tax deduction for a contribution to a nondeductible IRA. However, the earnings grow tax deferred until you begin to take distributions. Many of you know that you also do not receive a tax deduction if you make a Roth IRA contribution. Once you begin taking distributions they are tax free subject to certain rules.

Due to the low income tax rate environment in recent years, many people have not contributed to nondeductible IRAs. Since the $100,000 conversion rule is lifted in 2010, a new strategy is to contribute now to a nondeductible IRA and convert the balance to a Roth IRA in 2010. Each individual can contribute $5,000 ($6,000 if over 50) to a nondeductible IRA in 2008-2010. The nondeductible contributions (the tax on any earnings can be paid 50% on your 2011 return and 50% on your 2012 return) will not be taxed at conversion, but there is a catch that can best be explained by example.

Assume you have two IRA accounts: The first is an IRA composed entirely of deductible contributions and is valued at $500,000. Let's assume it was a rollover IRA from a former employer's 401k plan. The second includes nondeductible contributions in the amount of $20,000 and the account is valued at $30,000 ($10,000 of earnings). The IRS considers any amount you convert to come proportionately from pre and post tax contributions as well as earnings. In the example above, if the individual chose to convert $250,000 of their IRA balances to a Roth IRA only $9,433 of the $250,000 distribution would escape tax.

Even if you do not fund a traditional nondeductible IRA there are situations where you should consider converting your deductible IRA to a Roth IRA. Some of these may include:

>> Having a long period of time before you need the assets
>> Expecting to be in a higher tax bracket after retirement
>> Owning a traditional IRA in a depressed stock market
>> A desire to pass tax free assets to a beneficiary (more below)

Provide a Tax Free Annuity for your Child or Grandchild

Is it possible that you have money in an IRA that you may not need for your retirement? Are you interested in turning that money into a multi million dollar benefit for your child or grandchild? Here is a way to possibly do that.

Let's assume you have $150,000 in your IRA. The first step is converting the IRA to a Roth IRA in 2010. Yes, you will need to pay tax on the conversion with outside funds as discussed above, but this could result in a small estate tax savings by reducing your taxable estate. Think of it as paying your child's tax liability gift tax free. You now have a $150,000 asset that will grow income tax free.

The second step is naming your spouse as beneficiary of your Roth IRA and a child or grandchild as contingent beneficiary. Unlike children or grandchildren, a spouse can inherit your IRA and make it their own. And, since a Roth IRA does not require minimum distributions, the money can grow untouched during your spouse's life. At your spouse's death, the money would then transfer to your child or grandchild.

At this point your child or grandchild must begin taking minimum distributions based on their life expectancy.

Going back to our example, let's assume through your and your spouse's lifetime, say 25 years, your Roth IRA is now worth $1 million (assumes an 8% compounded rate of return). Let's further assume your 30 year old granddaughter is your beneficiary. If she limits her withdrawals to the required minimum each year, you possibly just passed on a tax free annuity to her that results in well over $3 million in payments.

And the best part… she will not pay a dime to Uncle Sam!

If you are interested in hearing more, call us to talk through the details.

Location, Location, Location: Asset Location is Very Important

by William H. Noble

All of the principals of The Trust Company of the South (Trust Company) regularly advocate the many attributes of asset allocation and diversification. However, we also believe that enough cannot be said about asset location…where your assets are located or held (tax-deferred vs taxable).

It is important to understand that different asset classes and investment vehicles have different tax (and income) related characteristics and where you hold these assets (tax deferred accounts vs. taxable accounts) can add significant value to your long term investment returns.

Generally speaking, it is better to hold assets that throw off consistent or regular income (i.e. bonds or bond funds) in tax deferred accounts (like IRAs and 401(k)s) and assets that provide long term capital growth (i.e. stocks or stock funds) in taxable accounts. The hypothetical illustration given below provides an example of how strategic asset location can enhance your investment performance.

ASSUMPTIONS*	TAX INTELLIGENT INVESTOR	TAX NON-INTELLIGENT INVESTOR
> $1,000,000 portfolio	> Holds bonds in tax-deferred 401(k)	> Holds bonds in taxable account
> 10-year time period, same return	> Holds stocks in taxable account	> Holds stocks in tax-deferred 401(k)
> 50% stocks/50% bonds	> Amount lost to taxes annually: $1,875	> Amount lost to taxes annually: $8,750
> 35% marginal tax rate	> Portfolio value: $1.7MM	> Portfolio value: $1.5MM

As you can see, the results of where your assets are located can have a significant impact on an investment porfolio's long-term performance. The tax intelligent investor comes away with an extra $200,000 merely by having his assets held in the most tax efficient vehicles. This is a very basic example and these benefits can be even more significant when multiple asset classes are taken into account. Trust Company always considers asset location as an important component to providing integrated counsel to all of our clients. We will talk about titling of assets in our next issue.

* Source: Vanguard

Interesting Times, continued from cover

stagnant economic growth over an extended period of time gave rise to the dreaded "stagflation." Bernanke argued the Fed has learned the lessons of the 1970s and is carefully monitoring inflation expectations, which fuel long-term price increases. If consumers expect prices to keep rising, they buy immediately, increasing demand and price pressures, that increase wage demands, that lead to even higher prices. Bernanke sees little evidence that such a spiral is underway now. While we have soaring commodity prices, increasing inflation and unemployment and a weak dollar similar to the 1970s, the economy has changed significantly and the differences are more telling than the similarities. Bernanke feels the economy is more open, flexible and energy-efficient and that the higher productivity of workers (due largely to technology) will enable employers to produce more without increasing overall labor costs, keeping prices lower. He also commented that the inflation rate, while higher than the desired 2 to 2.5 percent, has run around 3.5 percent for the last year *[actually 4.2% through May]*, compared to 10 percent in 1975, the year Bernanke graduated from Harvard. Nevertheless, the Fed must steer our economy 'twixt' Scylla and Charybdis. They have been cutting short term rates to avoid a recession, but they also want to raise rates to minimize inflation and strengthen the dollar, to counter the effect of run-away oil prices, budget and trade deficits. Recent moves to tighten the money supply and public comments by various Fed members indicate a shift toward flat to higher interest rates in the intermediate term, shifting the focus from recession to inflation avoidance. The Fed seems willing to *"walk the walk."*

Now that I Understand the Issues, What Should I Do?

First of all, disregard the late night talk show host supposedly quoting a spokesperson for United Arab Emirates Airlines that they have initiated a non-stop flight from the U.S. to Dubai to "give Americans a chance to visit their money." Focus instead on long term investment goals and needs. What distributions will you need from your account over the next year or two? What is your investment horizon? How much risk are you comfortable taking? Large Blue Chip multinational companies profit from a weak dollar, due to increased exports. The world economy is no longer controlled solely by the vagaries of the U.S. economy. Other countries might have more vibrant economies and investment opportunities today. Use today's issues as a reason to revisit your long term investment objectives. A thoroughly diversified portfolio, with domestic and international, large and small cap, developed and emerging markets and fixed income and equities, should weather the current situation.

During these *interesting times* in which we live, prudent asset allocation, with careful monitoring and periodic adjustment, will facilitate investment success – a blessing, rather than a curse. To be informed is to be enabled… We are here to enable you to succeed.

Behind the Scenes at Trust Company of the South

>> **John Slayton, Bill Noble** and **Chris Sutherland** recently attended the NC Bar Estate Planning Conference in Asheville, North Carolina.

>> **Dan Tolomay** and **Jill Sweat** recently attended a peer exchange session called "Deep Smart" with the Abacus Planning Group in Columbia, South Carolina.

>> **Bill Noble** was recently re-elected for a three-year term as treasurer and investment committee chairman for the Nash Community College Foundation.

>> We are pleased to announce that **Jay Eich** and his wife, Lindsey, welcomed a son, Daniel Stone Eich, who was born June 28, 2008. Congratulations Jay and Lindsey!

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