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THIS ISSUE...



# The Wild, Wild World of "Investment Consulting"

**by Mike Palmer, CFP®**

As a general rule, I'm skeptical when it comes to most things involving money. If something, someone or some notion involves separating me from my money, I tend to follow the old saw about what happens when a man with experience encounters a man with money -- the man with experience gets the money and the man with money gets "experience."

Over the last several months I've seen more than a dozen articles, both in the mainstream and financial press, addressing financial "consulting" – a nebulous term describing the kabuki dance performed by financial advisors serving the institutional investor community. For years these institutional investors (endowments, foundations, 401k plans and pension plans) have been plagued by so-called "investment consultants" – purportedly for hire to provide independent and objective investment advice and help institutional investors, led largely by volunteer boards, navigate the investment labyrinth.

The City of San Diego recently settled a lawsuit with its pension plan consultant, Callan Associates, for $4.5 million. The suit claimed that Callan steered asset management business to firms that paid to attend a Callan educational program and did not adequately disclose this apparent conflict of interest.

A report on *Bloomberg.com* states that asset management firms (the very firms Callan recommends to institutional investors) pay $16,000 to $51,000 to attend the Callan Investments Institute, which Callan describes as an "educational institution." This practice, known as "pay-to-play" is legal as long as it is disclosed, but good luck finding the details in Callan's ADV. According to Diann Shipione, a trustee of the San Diego pension fund, Callan "refused to disclose to me the extent of their financial relationships with the managers when I asked."

If this lack of full disclosure isn't enough, the process by which many "consultants" go about selecting money managers is equally unsettling. The emphasis on five year performance history was reported in a January 26 *Wall Street Journal* article titled "The Mutual Fund Eraser." The article highlights the consultant's dependence on five-year performance history as a basis for manager selection, and how the "roll off" of the 2000

continued back cover

**NOTABLE QUOTE**

**"Beware of little expenses. A small leak will sink a great ship."**

**Benjamin Franklin**

The Trust Company of the South is a fee-only independent trust company and financial planning firm focused on serving the needs of affluent individuals, families, and non-profit institutions.

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

# 2006 Tax Return Savings Tips

by John H. Slayton, JD, LLM-Tax, CFP®

As you prepare your 2006 tax return, you sit down with your CPA to work through it, or you plan for 2007, here are some changes to keep in mind. President Bush signed the 900+ page Pension Protection Act of 2006 ("PPA") on August 17 and the Tax Relief & Health Care Act of 2006 ("TRHCA") on December 20, 2006. Some of these changes occurred after the tax forms were finalized, but they all could save you taxes.

>> **Residential Energy Credit** – For 2006, you qualify for up to a $500 credit, equal to 10% of the cost of windows, skylights and outside doors, high efficiency furnaces, water heaters and central air conditioners. A 30% credit for solar power products is capped at $2,000 each for furnaces and water heaters.

>> **Phone Tax Refund** – The government was required to stop charging the 3% federal excise tax on long distance on August 1, 2006 and refunds are available for taxes between March 1, 2003 and then. You can either claim a "standard" credit of between $30 and $60, depending on your filing status, or the actual tax paid that you can prove.

>> **Hybrid Car Credit** – If you purchased a hybrid vehicle during 2006, you can claim a credit of up to $3,400, depending on the make and model, with the full credit limited to the first 60,000 vehicles each auto manufacturer sold after 1/1/06. For example, a Toyota Prius purchased prior to October 1 qualifies for a credit of $3,150, but only $1,575 if purchased later.

>> **Deduct More Long-Term Care Premiums** – More long-term care insurance premiums are included in deductible medical expenses. Filers aged 61-70 can claim $2,830; 51-60 can claim up to $1,060; 41-50 can claim up to $530; and younger can claim up to $280.

>> **Higher Income Limits for Deductible IRAs** – If you are covered by a retirement plan at the office, a full IRA deduction is still available for married filing jointly AGIs of $75,000 (up $5,000) or if your spouse is covered at the office, you can make a fully deductible IRA contribution if your joint AGI is under $150,000, with a phase-out for higher incomes.

>> **Tougher "Kiddie" Tax** – For children 17 or younger (up from 14), any unearned income over $1,700 will be taxed at the parents' marginal tax rate, not the child's.

>> **Increased Section 179 Deduction** – The maximum amount a business can deduct in lieu of depreciation (the expensing deduction) increased by $3,000 to $108,000 for assets placed in service in 2006.

>> **Higher Standard Mileage Rates** – The standard rate for business driving in 2006 is 44.5 cents a mile; 48.5 cents in 2007.

>> **Reduced Squeeze on Itemized Deductions and Personal Exemptions** – For 2006, the trigger point for losing parts of deductions is $150,500 (regardless of filing status). For 2006 and 2007, affected taxpayers lose these deductions at a rate of 2% (1% for 2008 and 2009) of the amount by which their AGIs exceed the trigger point. For 2006, reduction of personal exemptions begins at AGIs of $227,750, but the value of these personal exemptions cannot be reduced below $1,100.

>> **Premiums for Mortgage Insurance** – Incurred in connection with acquisition indebtedness for a qualified residence is now treated as qualified residence interest.

>> **Certain Expiring Tax Breaks Extended for 2 Years** – Above-the-line deduction up to $4,000 for qualified tuition; election to deduct state and local general sales tax (if no state income tax); research credit extended and increased to 3%; and miscellaneous others.

>> **Student Loan Interest Paid by Mom and Dad** – Is treated as a gift to a child who is not claimed as a dependent, and the child can deduct up to $2,500 interest paid on student loans by parents.

>> **More User-Friendly Health Savings Accounts (HSAs)** – HSA contributions are no longer capped by the amount of the deductible of the high-deductible health plan. For 2007 taxes **(not 2006),** the annual maximum HSA contribution is $2,850 for an individual or $5,650 for a family, indexed for inflation and not

prorated according to the remainder of the year after contribution.

>> **Unrelated Business Taxable Income of Charitable Remainder Trusts** – Is now subject to a 100% excise tax, instead of the old rule that voided the income tax exemption of the CRT for any year it had UBTI.

>> **Written Substantiation of Charitable Contributions** – Are now required from all charities, even from private family foundations. Cancelled checks are no longer adequate, but emails should be.

*These rules are not new, but they might save you some taxes:*

>> **State Tax You Paid Last Spring** – Remember to include state income tax you paid when you filed your 2005 state tax return last spring with state tax withheld or paid-in quarterly during 2006 in calculating your deduction for state income tax.

>> **Reinvested Mutual Fund Dividends** – Remember to add automatically reinvested mutual fund dividends to your tax cost basis in the fund, to reduce the capital gain when you redeem the funds.

>> **Moving Expenses to Take First Job** – You cannot deduct job-hunting expenses incurred while looking for your first job, but moving expenses to your first job are deductible even if you do not itemize. If you moved more than 50 miles, you can deduct the cost of getting yourself and your household goods to the new area, including 18 cents per mile, plus parking and tolls.

>> **Estate Tax Exemption** – Up to $2 million in 2007 and 2008, $3.5 million in 2009, zero estate tax in 2010 and back to $1 million exemption in 2011. **Count on this to change.**

>> **Estate Tax on Income in Respect of a Decedent** – If you inherited an IRA from someone who had a federally taxable estate, you get an income tax deduction for the amount of estate tax paid on the IRA balance, prorated as you draw money from the IRA and pay income tax.

*The PPA also included some favorable provisions pertaining to retirement plans, IRAs, rollovers, catch-up contributions and Roth 401(k) plans.*

>> **Approved Non-Spousal Qualified Plan Rollovers to IRAs** – Similarly to powers provided to spouses previously, non-spousal beneficiaries may now establish inherited IRAs and transfer, "trustee-to-trustee," qualified retirement plan assets to the inherited IRA. This permits withdrawals from the IRA according to the beneficiary's life expectancy, rather than on the prior expedited schedule.

>> **2001 Tax Act Pension and IRA Changes Made Permanent**

- *Increase in Maximum Deductible IRA Contributions* – $4,000 in 2006 and 2007 and $5,000 in 2008, inflation-adjusted starting in 2009 and subject to a $1,000 annual catch-up if you are over 50.
- *401(k), SEP and 403(b) Plan Deferrals* – Increased to $15,000 per year, inflation adjusted starting in 2007, with a $5,000 annual catch-up if you are over 50.
- *Increased Covered Compensation and Contributions for Defined Contribution Plans* – 2006 covered compensation of $220,000 and maximum contribution amounts of $44,000, inflation adjusted in 2007 and after.
- *Maximum Benefits Under Defined Benefit Plans* – $175,000 in 2006, inflation adjusted.
- *Direct Rollovers From Qualified Plans to Roth IRAs* – no longer requires 2-step transfer through a traditional IRA to a Roth IRA.

>> **Section 529 Plan Provisions are Now Permanent.**

>> **Tax Refunds Can Now be Directly Deposited into an IRA.**

Clearly, the Congress had a busy and productive 2006; hopefully resulting in some tax savings. It will be interesting to see whether the new majority will continue the trend.

## Behind the Scenes at Trust Company of the South

- >> **Mike Palmer** has been appointed to a two-year term on the TIAA-CREF Board of Financial Advisors. The board is comprised of ten leading financial advisors from across the country.
- >> **John Slayton** attended the 41st Annual Heckerling Institute on Estate Planning, sponsored by the University of Miami School of Law.
- >> **Will McPherson** was named the 2006 Rookie of the Year for the Greensboro Jaycees.
- >> **John Slayton** presented a session on "Modern Trustee Investing" at the 8th Annual Elon University Department of Accounting & Finance Seminar in November.
- >> **Mike Palmer** authored the October issue of *Investment Advisor* magazine's "Soapbox" column titled "Legacy and Fungos."

## How We Add Value

**One of our clients will be taking a semester sabbatical starting in February to teach in New Zealand. In preparation of his temporary change in employment status at UNC, we met with the client and a representative of the UNC benefits office to make sure we had a thorough understanding of how our client's leave would affect his benefits.**

**During this review we noticed a payroll deduction for disability insurance coverage. "Could you tell me to what age the disability coverage pays?" I asked the benefits representative. She replied that she did not know. She excused herself from our meeting and went to check with another benefits person. We soon learned that the group disability coverage paid benefits to age 65, which is typical of most group disability plans. Since our client was older than age 65, we terminated the payroll deduction and have made a claim for a refund of premiums previously paid. It is important to review payroll deductions and increasingly, as folks work beyond the normal retirement age, to understand the specific coverage limitations of group benefit plans.**

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and 2001 performance makes some managers look especially attractive. Money manager Kevin Divney was quoted as saying that until recently, "…the consultant and adviser community would say, 'No one wants to talk to you, because of your five-year number.'"

In our view, all this magnifies just how poorly most institutional investors are served. I must confess to being a disciple of Occam's Razor – a principle that states the simplest solution tends to be the best. In our capacity as investment advisor, we believe this is accomplished by embracing full fee transparency, serving clients in a fiduciary capacity, and implementing an investment strategy founded upon low cost, capital market investing. Investment success isn't achieved by taking advantage of pricing mistakes or accurate predictions of the future. Too often, this approach proves costly and futile. Markets throughout the world have a history of rewarding investors for the capital they supply. It is a principle as sound as it is simple. Certainly one that William of Ockham would embrace were he alive today.

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