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Vigil Trust & Financial Advocacy

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## Asset Divestment and Protection

Protecting your assets incase you ever need long-term care is an extremely long and complex area of law. It is really impossible to describe the seriousness and complexity of planning in this area without occupying hundreds of pages of space. The deficit Reduction act of 2005 (“DRA”) was signed into law by President Bush on February 7, 2006. While the State of Wisconsin has had over two years to implement state specific plans they have not. The federal change of note is the look back period for divestment from individuals from 36 months to 60 months. The consequences of one misstep when planning to protect and divest your assets can be potentially devastating for someone in need on long-term care and the spouse who remains in the community. Old strategies for protecting your family assets should be looked at and reviewed. If you recently haven’t discussed long-term care options with your advisor now may be a good time to see if this strategy makes sense for your specific situation. ✓



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# VIGIL Strategies

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Second Quarter Newsletter 2008

## Are Foxes Watching Your Hen House?

The other night I was engaged in one of my favorite things to do (not!): sorting through bills from medical providers and reconciliations from my health insurance company to determine how much of the medical bill I still owed. Perhaps you share my passion for this exercise?! But on this night I paid particular attention to medical charges that were reduced either because they were “charges in excess of reasonable and customary charges” or because they were subject to a “negotiated provider discount”. These reductions in my medical provider’s bill let me know that my insurance company was on the lookout for me in making sure I wasn’t being charged too much for the services I received and in negotiating appropriate reductions in servicing costs where possible.

As I sat there in a state of baffled bewilderment, the whole situation with medical care decisions, costs and insurance company involvement in that process called to mind an article I had just been reading relating to retirement plan investments. Many of the truly good initiatives in the world of managing finances start in the retirement plan area with Department of Labor concern over a particular practice and mushroom into something that applies to all investing activity. In this case, I had been reading about a Dept. of Labor initiative regarding the reasonableness and fair and complete disclosure of fees charged by providers of investment and other services to

retirement plans. The concern is with the significant “imbedded” fees (fees that are not separately reported and that are deducted prior to the presentation of investment return) that are involved with investment options offered to retirement plan participants. The point of this initiative and of a bill that is trying to work its way through the House of Representatives (H.R. 3185) is that retirement plans are riddled with high, hidden costs that are causing a corresponding reduction in the return received by participants. This reduced return is jeopardizing the retirement of millions of Americans, most of whom are oblivious to the fact that this is even occurring.

This problem is not limited to retirement plans; we see people every day who are suffering from reduced returns due to imbedded costs in the investment products sold to them by investment product purveyors, many of whom try to convince their clients that paying someone to watch out for their best interests is an unnecessary waste of money. The Department of Labor and Congress would disagree. The problem they are wrestling with is that in the retirement plan context (unlike the rest of the investment world) there IS someone who is supposed to be on the job watching out for the best interests of the plan participants – the plan *fiduciary*. Unfortunately the DOL and Congress are concerned that these fiduciaries are not getting the job done, most often because they are businesspeople consumed with the daily responsibilities of running their business. If they have no background in or particular acumen for investing, this lack of knowledge and experience combined with a very complicated and purposefully designed system for charging fees that are not readily apparent means that product purveyors are having a virtual financial field day at the expense of the retirement well-being of many Americans.

(By the way, are businesspeople who don’t have the time, knowledge or experience to monitor investments in their retirement plan and their hidden costs really all that much

different from the average American investing their own money?)

The DOL and congressional idea to help deal with this problem is to require complete disclosure of fee information to the people already in a position to protect plan participants – the plan *fiduciaries* – with the hope that

they can do a better job of discharging their duties armed with this information. Guess who is opposed to these initiatives? The insurance and mutual fund companies who have been deducting huge hidden fees for their own benefit and causing participants to accumulate much less for their retirement.

And what about non-retirement investments? Are they any less susceptible to substantial, unknown hidden costs? Are individuals without a great deal of investment background who are involved with their own jobs, families and leisure activities really in a better position than businesspeople to discover cleverly hidden costs that soak up returns? Shouldn’t they be afforded at least the same, if not greater, protections?

At least in the retirement plan context there is someone who is arguably in a position to protect the best interests of participants – the plan *fiduciary*. But who protects the individual? Of course there are professional *fiduciaries* that you can hire to provide this service to you. But there is a cost. And guess who makes the compelling case that those kind of costs are a waste of your money? You guessed it – the brokers and others who have the most to gain by preying on your lack of knowledge and experience in this area.

When I was growing up my parents used to tell me some things were like the “fox guarding



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## Hen House *continued from page 1*

the hen house". When we have retirement plan fiduciaries armed with inadequate information (and in some cases knowledge and experience) to assess their options and when we have many individuals going completely "naked" in terms of having someone to protect their interests, isn't that almost the exact definition of leaving the "fox to guard the hen house" in terms of planning your financial future and your investment activities?

If you die and leave your money in a trust for your children, do you think a court would appoint a broker or a mutual fund or insurance company as the trustee of that trust? Of course not. Why not? Because the court does not want a "fox guarding the hen house"! The court requires that a *fiduciary* be appointed – despite the added "cost" – to protect, rather than take financial advantage of, your children. Are you so much more knowledgeable and experienced in these matters that you don't need that help yourself?

When you go into your doctor's office, do you ask how much the visit is going to cost? A friend of mine just had emergency surgery to put 4 stents in his arteries to rescue him from a heart attack. Do you think his wife was asking the physician "how much is this going to cost?" before authorizing the procedure? Of course not. Don't get me wrong – I have some of the same problems you do with insurance companies. But at least in this respect, isn't it nice to know that when you have medical treatment you've got the insurance company at work for you confirming that the procedure is necessary for your situation and that you are paying a reasonable cost for what you are receiving – that is, that you are getting good *value* for your money spent? (Notice I did NOT say "lowest cost". Do any of us really choose a medical care provider because they "cost the least"?) I submit you are entitled to and should be receiving the same sort of knowledgeable, experienced protection when it comes to managing finances – whether through educating those already in that position or hiring someone to do that for you. It is money well spent to ensure that you don't have foxes in your financial hen house. ✓



Tom Batterman  
President  
Vigil Trust & Financial Advocacy

## Taxes Can Kill a Good Retirement Plan

Most retirees rely on a patchwork of income sources in retirement. Pension income, IRA distributions, Social Security, income from work, and taxable investment returns all may contribute to your income in retirement. By the time you add them all up, you could end up with a whopping tax bill. And when you consider the "stealth taxes" that sneak in at certain levels of adjusted gross income, you could wind up paying more in taxes than you did when you were working. So much for the assumption that you will be in a lower tax bracket in retirement.

Here are some examples of how too much income (i.e., adjusted gross income, or AGI) can add to a your tax bill, creating a higher marginal tax rate than the tax tables would suggest:

**Itemized deduction reduction.** If AGI is more than \$159,950 (single or married) or \$79,975 (married filing separately) in 2008, certain itemized deductions are reduced. This means you may not reap the full benefit of deductions taken for charitable contributions, interest expense, and state and local taxes. (Deductions for medical expenses, investment interest, and casualty and theft losses are not affected by this phaseout rule, which is in the process of being eliminated and will be gone by 2010.)

**Personal exemption phaseout.** The personal exemption deduction of \$3,500 per person in 2007 is reduced when AGI exceeds \$239,950 (joint) or \$159,950 (single) and is fully phased out at \$362,450 and \$282,450, respectively.

**2% floor for miscellaneous expenses.** The higher the AGI, the higher the hurdle is for deducting miscellaneous investment and job-related expenses.

**7.5% floor for medical expenses.** Ditto for medical expenses, which may include

such typical retiree expenses as long-term care costs and premiums for LTC insurance policies.

**Alternative minimum tax.** Retirement doesn't protect you from the AMT, which forces high-income you to pay more than the regular income tax.

**Higher Medicare Part B premiums.** In 2007, Medicare beneficiaries with higher incomes started paying more for Part B. The basic \$96.40 monthly premium in 2008 will be increased to:

\$122.20 for married couples earning between \$164,000 and \$204,000 and individuals earning \$82,000 to \$102,000  
\$160.90 for married couples earning \$204,000 to \$306,000 and individuals earning \$102,000 to \$153,000  
\$199.70 for couples earning \$306,000 to \$410,000 and individuals earning \$153,000 to \$205,000  
\$238.40 for couples who earn more than \$410,000 and individuals who earn more than \$205,000

The beauty of retirement income planning is that your advisor can often design the income portfolio to give you just the right amount of taxable income—enough to meet current spending needs but not so much that it becomes counterproductive from a tax standpoint. But you must start the process early, because required minimum distributions starting at age 70½ reduce your opportunities for tax finagling. By mapping out your future income stream the day you officially retire—that is, when you switch from an accumulation to a distribution strategy—you can work with a your advisor to plan for the timing, amount, and taxation of the various income sources.

Here's a rundown of how the various sources of retirement income may be taxed.

### Pension payments

A person who elects to receive his employer-sponsored retirement distribution in the form of periodic payments will pay tax on all or part of the income. Only if they have made after-tax contributions to the account will a portion of the income be nontaxable. The nontaxable portion is prorated over the annuity period, which is determined by their age at the starting date.

To calculate the nontaxable portion, your investment in the contract is generally divided by the expected number of monthly payments: 360 if your 55 or younger at the starting date, 310 if 56 to 60, 260 if 61 to 65, 210 if 66 to 70, or 160 if 71 or older. If the contract is based on two lives, the nontaxable portion is calculated by dividing your investment in the contract by 410 if the combined age of the annuitants is 110 or under, 360 if 111 to 120, 310 if 121 to 130, 260 if 131 to 140, or 210 if 141 or over.

There are lots of rules and exceptions pertaining to the taxation of pension income, so it's best for your advisors to help you figure it out. The main thing you should understand is that choosing the annuity option, as opposed to taking a lump-sum distribution and rolling it into an IRA, will set your taxable income in stone. You will not have the option to change the amount of monthly payments, and the taxable portion (which may be all of it) will be established at the outset and continue for the rest of your life. This could be a disadvantage if tax rates change or if you have a significant tax event that throws you into a higher bracket without the flexibility to rearrange your other income from one year to the next.

### IRA distributions

Between the ages of 59½ and 70½ you have great flexibility when it comes to managing your tax picture through IRA distributions. If you don't need income for spending, you need not take taxable distributions.

But the picture changes significantly at age 70½, when you must start taking required minimum distributions (RMDs). You no longer have a choice about how much taxable income to receive each year. Advance planning is essential with large IRAs if you want to have more flexibility over your tax picture after you turn 70½. Here are some options.

#### Start siphoning off IRA income early.

The larger the IRA, the larger the RMDs will be starting at 70½. But if you work to reduce the IRA through judicious distributions before then, you may be able to reduce the total tax paid on IRA income. Some tax advisors recommend taking enough in annual IRA distributions to fully utilize the 15% or 25% bracket in order to whittle down the IRA before age 70½.

**Convert to a Roth IRA.** Converting a traditional IRA to a Roth IRA is an obvious

way to reduce taxable income in retirement. This also requires advance planning because of the income limitation on eligibility (\$100,000 AGI through 2009) and the need to budget for a big tax bill in the year of conversion. Depending on your circumstances, you may need to plan for the Roth conversion in a future year or do it piecemeal over several years. Note that in 2010 the income limitation will be lifted and the taxes on Roth conversions done in 2010 may be paid over 2011 and 2012.

### Social Security benefits

Here's an area where attention to your income can make a difference in more ways than one. Not only is the other income subject to tax, but it may also cause Social Security benefits to be taxable. If your "provisional income" is more than \$44,000 (joint) or \$34,000 (single), 85% of Social Security benefits are taxed. (Provisional income includes all taxable income, tax-exempt interest, and one-half of Social Security benefits.)

So if you receive the maximum benefit at normal retirement age in 2008 (\$2,185 per month) and your provisional income exceeds the threshold, you will pay taxes on \$22,287 of Social Security income (\$2,185 x 12 x 85%). The amount of tax would be \$3,343 in the 15% bracket or \$5,572 in the 25% bracket. You may want to try to eliminate this tax by keeping your income below the threshold; others may have no choice but to pay up.

### Income from work

Another way you can become ensnared in the taxation web is to earn income from work. This results not only in the regular (or AMT) tax on the income, it also may reduce Social Security benefits if you have not reached full retirement age. (For those who have not reached full retirement age, one dollar in benefits will be withheld for every \$2 earned above \$13,560 in 2008.) And if it adds enough taxable income to throw you over the "provisional income" threshold for the taxation of Social Security benefits as described above, it's almost enough to send even the most ambitious retirees to the rocking chair, where they will be safe from further taxation.

The obvious solution here is to delay taking

Social Security benefits until you have reached full retirement age, at which point working does not cause a reduction in benefits, or until age 70, when it no longer pays to delay.

### Income on invested assets

Vigil Trust can help you control your tax bill by paying attention to the taxable income that gets thrown off by investment activity. This is especially important for retirees, because of the impact on Social Security taxation and the other tax benefits they might miss out on by having too much income, such as the 7.5% floor on the medical expense deduction. As always, you will need to integrate your income tax needs with your other investment objectives, including their risk tolerance and current spending needs.

Tax planning is crucial for you when preparing for retirement owing to the interconnectedness of the various tax rules. Actions in one area can have a larger-than-expected impact on another. In the years leading up to retirement—and for anyone already in retirement who has not done such planning—be sure to look at all the angles and enlist your advisor for assistance in making crucial decisions. ✓

## Thank You

Thanks again to all of our clients and professional colleges who continue to refer the services of our firm. It feels great to have your support behind what we do at Vigil Trust and Financial Advocacy. The success of this firm is greatly attributed to your vote of confidence.

Do you have someone you think we should meet but don't know how to approach the subject with them? How about a lunch date with you and them? Our treat of course. Just give Heather a call at 715-848-8110 or email her at [hsummers@trustvigil.com](mailto:hsummers@trustvigil.com) to arrange a time and location.