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"TIPRA" Primer

How changes in the 2005 tax law may affect you.

(1) As the tax ensnares more middle class families, the demand for permanent repeal will likely reach critical mass. The problem is that the tax is becoming a major source of revenue for the government. By 2010, the collections from this tax may reach an estimated 1% of GDP. Repealing the AMT would cost the government an estimated \$1.2 trillion over the next 10 years. This would require an 11% tax increase to replace the lost federal revenue. Keep in mind, however, that this assumes a static analysis of tax revenues. Tax cuts could result in higher federal collections in the future, as demonstrated by the 2003 tax cuts.

(2) Factors include level of income, current and future tax rate assumptions, time horizon, method of paying taxes on the reported income, expected rate of return and retirement income strategy. Keep in mind that a conversion will result in higher reported income, which may push you into a higher marginal tax bracket and reduce the net benefit.

(3) Previously, a child under the age of 14 paid no income tax on the first \$800 of income. The next \$800 in income (from all sources) was taxed at the child's tax rate—usually 10% or 15% for ordinary income and 5% for capital gains and dividends. Income over \$1,600 was taxed at the parents' applicable tax rate—up to 35% on income and 15% on capital gains and dividends. Beyond age 14, the child paid taxes on unearned income at his or her personal rate.

Anyone expecting substantive tax reform this year will be disappointed with the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). The bill offers only temporary fixes on a number of issues that have plagued tax policy. As it stands now, the temporary nature of these provisions makes longer-term planning difficult.

Nevertheless, the new tax law has a few key rule changes worth addressing. These include:

• **Capital gains and dividends:**

TIPRA extends the 15% rate on capital gains and qualified dividends through 2010. Taxpayers in the lowest personal tax brackets (10% and 15%) will see capital gains and dividend rates stay at 5% through 2007—then fall to 0% in 2008, 2009 and 2010.

This three-year grace period offers a gifting window with possible future tax advantages. For instance, parents can give up to \$12,000 in appreciated assets to children who expect to be in a lower marginal tax bracket later. If they can wait until 2008, 2009 or 2010 to sell the assets, the children will owe no tax on the gains.

• **Alternative Minimum Tax (AMT):** TIPRA increases the 2006 AMT exemption amounts to:

- \$62,550 for joint married filers
- \$42,500 for single filers
- \$31,275 for separate married filers

This helps more people avoid exposure to the AMT. The new law also reinstates the rules allowing non-refundable personal tax credits to offset the AMT. These include the dependent care credit,

credit for the elderly and disabled, Hope credit for college expenses and Lifetime Learning credit.

The AMT was created to prevent wealthy people from eliminating their tax bill with large deductions. Now the tax is snagging an expanding group of middle class taxpayers. In 2005, about 4 million people paid the tax. This would have jumped to 21 million in 2006 without the temporary fix. A recent report from Congressional Research Services predicts that 23 million Americans will fall prey to the AMT in 2007 without another stopgap measure. By 2010, the AMT could affect 33 million Americans—or about 95% of taxpayers with incomes between \$100,000 and \$500,000.⁽¹⁾



• **Roth IRA conversions:** Before TIPRA, anyone with modified adjusted gross income over \$100,000 could not convert a traditional IRA to a Roth IRA. The new law eliminates this restriction. Taxpayers earning above \$100,000 will have the chance to convert—but not until 2010. Those who do convert at that time can spread their reportable income over the next two years.

Elimination of the \$100,000 income limit opens the door to many higher-income taxpayers who have accumulated a large IRA and want to avoid paying taxes on mandatory withdrawals during retirement. Those who convert to a Roth IRA will pay income tax on the amount converted—but then never face taxes on future earnings, capital gains or retirement withdrawals in the account.

Many factors will influence whether the future benefit of tax-free distributions justifies the tax

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The Water Factor

Chronic shortages may affect markets and economies.

(1) The price trend is also observable on the consumption side of the market, where water utility charges keep rising. For instance, since 1989, water price increases have averaged 6.3% annually in California. ("Water Outperforms Oil, Luring Pickens, GE's Immelt, Guy Hands," Bloomberg.com, 27 June 2007)

(2) Source: "Water Outperforms Oil," Bloomberg.com, 27 June 2007.

More than 70% of the earth's surface is water. But 97% of it is saltwater, while only 1% is usable and readily accessible freshwater.

(3) Twenty percent of the world's population lives in China, while the country holds only 7% of the fresh water supply on earth. Per-capita water reserves are only about a fourth the global average, according to experts. Of its 669 cities, 440 regularly suffer moderate to critical water shortages. According to *World Scientist Magazine*, 30 cubic kilometers more water is being pumped to the surface each year than is replaced by rain—one of the reasons that the country has become dependent on grain imports from the West.

In various regions of India, farmers are pulling an increasing amount of water from the ancient aquifers to meet demand from growth in population, agriculture and industry. This amounts to about 200 cubic kilometers of water brought to the surface each year, while only a fraction is replaced by monsoon rains. At this rate, researchers expect groundwater supplies in some areas to be exhausted in five to 10 years. (Source: "Invest in the Coming Global Water Shortage," MSN.com, 1 Dec. 2005)

(4) Global warming threatens to disrupt traditional rainfall and runoff while increasing the frequency and severity of droughts and floods. The changing climate could also degrade water quality by affecting water temperatures, flows and runoff rates. ("Illiquid Assets, Worth," 1 Sept. 2005)

(5) "Now That's A Liquid Investment," *Business Week Online*, 18 April 2005.

* You cannot invest directly in an index. Past performance does not guarantee future results.

OIL, COPPER, GOLD and other commodities have captured attention in the recent market boom. Since 2003, prices of many raw materials have doubled or tripled. But water, one of the most essential natural resources, has not received deserved attention.

From 2003 through late June of 2006, the Bloomberg World Water Index returned 35%—compared to 29% for oil and gas stocks, and 10% for the S&P 500. This also beats the 27% return for the Bloomberg World Basic Materials Index, which includes 239 companies that produce commodities such as copper, aluminum, paper and steel.^{(1)*} Many analysts, hedge managers and wealthy investors expect water resources to continue appreciating over the next several decades.

Market pressure

The United Nations estimates that by 2050, over 2 billion people in 48 countries will be short of water. In some parts of the world—and especially where usable sources are limited or scarce, such as the Middle East—water may become even more valuable than oil.⁽²⁾

Although water shortages are likely to arise in developed economic regions (such as the Southwestern U.S.), the most likely scenarios involve developing economies, where demand growth could overwhelm supply and delivery capacity.

A market imbalance could arise from one or several of these common factors:

- Surging economic development
- Rapid industrialization
- Overpopulation
- Disruptive weather patterns
- Rising affluence
- Primitive water infrastructure
- Excessive pollution
- Disputed water rights

China and India are two developing nations where chronic water shortages may arise in the future.⁽³⁾ Higher personal consumption, modernized agriculture, industrial development and rising living standards have all contributed to spiking demand. Also, the negative effects of rapid development—including overcrowding, pollution and waterborne

disease—may combine with unexpected weather changes from global warming to reduce supply.⁽⁴⁾

The private approach

Water's economic value may be rising, but direct participation is impractical for most investors. Water is owned and controlled by governments. They set the price—and it's unlikely that any country would allow private control or market trading in their strategic resource.

In the private sector, companies that supply and service segments of the water industry may benefit from future water demand. These segments include water treatment, testing and filtration, pollution control, and water infrastructure (utilities, pipelines and sewage treatment). Governments and private companies, both in the U.S. and abroad, may have to spend large amounts on water infrastructure to expand supply, improve water quality and boost conservation. The Environmental Protection Agency estimates that spending on water network maintenance in the U.S. could exceed \$500 billion over the next 20 years.⁽⁵⁾

Although water is not an asset class with unique risk and return properties, it follows a pattern similar to other natural resources. In general, there is an inverse relationship to the overall stock market, although raw materials are more volatile and have a longer cycle than stocks. Development of new sources takes longer and often has a prolonged effect on market price.

Predicting future winners in the water industry through company stock analysis would prove elusive. But a diversified investment strategy should inherently capture the trend through ownership of domestic and global companies involved in various aspects of the water business. If low correlation with the broad stock market proves true, this could offer an additional risk reduction benefit.

Also, corporate managers—and especially those leading companies with holdings in politically sensitive regions—should consider how water availability may affect their industry, company profitability and risk exposure in the future. For example, Coca-Cola and Pepsi bottling plants in India had their licenses revoked in 2003 over allegations that the facilities were depleting groundwater stores.

More companies are factoring water into their strategic planning, production process, supply chain management, technology purchases and other decisions. Those who ignore these issues may get soaked. ■



Fighting Inflation

Is Federal Reserve policy losing its punch?

(1) Unemployment remains low, corporate profits strong; industrial output utilization above the long-term average, and consumer spending robust. Inflation-adjusted interest rates of 2.8% are just slightly above the 2.4% long-term average. ("A Do-Nothing Fed Is Looking Less Likely", *BusinessWeek*, 6 Nov. 2006, p 29.)

(2) In November, core inflation (excluding food and energy) was 2.7% year-over-year. Headline (overall) inflation was 1.3%. Declining energy costs of 11.3% annualized contributed to the falling overall rate. (Source: Bureau of Labor Statistics, 16 Nov. 2006)

(3) In late November, the dollar hit a 20-month low against the euro and 14-year low against the pound. Over the past year, it has dropped nearly 7% against the Fed's index of seven major currencies. ("Paulson's Challenge: To Let Dollar Decline Without Hurting Economy", *The Wall Street Journal*, 1 Dec. 2006, A1.)

(4) In Q3, manufacturing productivity rose 6.7% while unit labor costs fell 2.0% (year-over-year change). Ironically, in the foreign labor markets, U.S. businesses are suffering rapid wage growth. American companies went overseas to get cheap labor, but now are finding skilled labor in short supply and costly to hire.

(5) Since 1995, imports have risen from 12% to 17% of GDP, and foreign sources supply about 32% of U.S. domestic investment. Despite over a four percentage point increase in the Fed funds rate since 2004, the 10-year government bond was yielding 4.6% in late November—the same level as when the rate hikes began.

("Can Anyone Steer This Economy?", *BusinessWeek*, 20 Nov. 2006, pp 57-62.)

(6) Chairman Bernanke's hawkish inflation message runs contrary to a growing sentiment among economists that GDP is slowing, inflation risks are fading, and the Fed should prepare to strike an accommodative monetary policy in 2007. ("Bernanke Warns Inflation Remains A Significant Risk", *The Wall Street Journal*, 29 Nov. 2006, A11.)

WHEN THE Federal Reserve talks, people listen. Companies, economists, Wall Street, government and economy watchers all scrutinize messages offered by Fed officials and their leader, Chairman Bernanke. Their interpretations usually concentrate on the central bank's view of the inflation trend and the implications for interest rate policy.

The Fed tries to manage inflation and direct the economy by adjusting interest rates and the money supply. Some experts believe that these policy tools have lost potency and that many forces beyond the Fed's control now wield growing influence over inflation.

The evidence is found in the Fed's current challenge to contain inflation.

Despite 17 quarter-point rate increases since June 2004, the economy has remained stubbornly vibrant⁽¹⁾ and core inflation has moved beyond the Fed's 1-2% comfort zone.⁽²⁾

Let's consider some of the inflation determinants that are considered beyond the Fed's direct control:

• **Energy prices.** The Fed's policies have only distant leverage on global energy prices. Other factors, such as geopolitical tensions, worldwide supply and demand, OPEC policy, U.S. refining capacity, speculative trading and weather patterns all play a more vital role. This may be why the Fed tracks core inflation, which excludes food and energy from index calculation.

In 2006, energy usage remained strong even as oil prices pushed to record highs. Oil at \$70 per barrel may have modestly boosted core inflation—but also assisted the Fed by dampening economic growth as companies began to pass along higher fuel costs to consumers. But the dampening effect was short lived, as retreating oil prices are now easing inflation and may revitalize GDP growth.

• **Housing prices.** The Consumer Price Index (CPI) uses owner equivalent rent (OER) to measure home price inflation. But the metric can produce misleading data for the CPI when home

prices and residential rents diverge. This occurs when rising interest rates put downward pressure on home prices while pushing rents upward. Conversely, housing prices were climbing rapidly from 2003 to 2005—but rents stagnated. In 2006, rents began to catch up just as home prices began to fall.

• **Exchange rates.** Changes in the dollar's value relative to other major currencies can affect inflation. A declining dollar raises the cost of imported goods while also lowering the returns of foreign investment in the U.S. These changes ultimately impact future capital flows, the trade deficit and economic growth. In 2006, the dollar declined

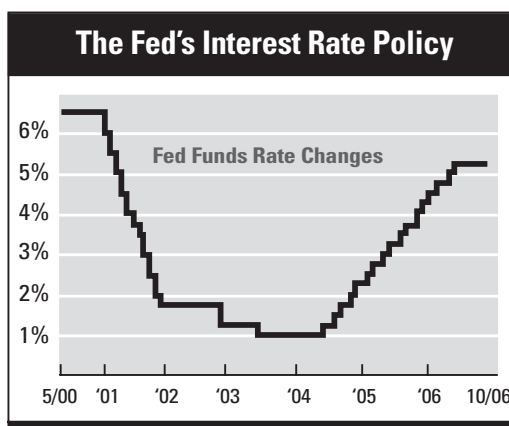
drastically against major currencies.⁽³⁾ Prices have not climbed considerably because some Asian economies peg their currencies to the dollar and other foreign exporters have been forced to cut prices to compete in the world market.

• **Labor costs.** Unemployment logged 4.4% in October and 4.5% in November—well below the Fed's forecasted 4.75-5.0% range. Strong

employment drives up wages, which raises business costs and squeezes profit margins. But in the current expansion, wage growth has been weak, as rising productivity has restrained unit labor costs.⁽⁴⁾

• **Global economic forces.** Today, the U.S. economy is more closely linked to global forces. Imports and foreign investment are two major inputs. The Fed must implement policy amidst an overwhelming flow of goods and money across national borders. This may be one reason why the Fed's rate hike campaign that began in 2004 has yet to produce a convincing economic slowdown. Cheap imported goods have kept prices contained while foreign capital flowing into the U.S. markets has offset the Fed's attempt to reduce the supply of money and credit.⁽⁵⁾

This weakened policy clout may reduce the chances that the Fed will navigate a soft landing. The CPI and other key indicators are delivering mixed signals on real inflation and economic strength—and this lack of clarity may keep the markets guessing. While more economists are predicting a 2007 slowdown, Fed Chairman Bernanke recently observed that the economy is strong, inflation remains "uncomfortably high", and future rate increases may be needed to quell economic growth and subdue inflation.⁽⁶⁾ ■



Source: Federal Reserve Board

TIPRA Primer

(Continued)

paid upon conversion.⁽²⁾ In most scenarios, a total or partial Roth conversion will result in net tax *savings* during retirement—especially if you have a long time horizon, pay conversion tax with outside (nonaccount) money, and/or expect marginal tax rates to stay level or rise in the future.

• **“Kiddie tax” expanded:** This provision sets limits on the amount of unearned income a minor dependent can claim and pay at his/her low marginal tax rates. TIPRA increases the relevant age of children subject to kiddie tax from 14 to 18.⁽³⁾ In 2006, the first \$850 of a minor’s unearned income is tax-free. The second \$850 is taxed at the child’s lowest applicable federal rate—typically 10% or 15% for income and 5% for capital gains and dividends. Additional unearned income is then subject to the parents’ marginal rate.

This change affects several groups of taxpayers, including, (1) families that gift assets with significant appreciation or short-term appreciation potential, (2) parents who were or are still saving for their children’s college using custodial accounts, and (3) any minors who are saving large amounts of their own money for college and will get taxed at their parents’ rates on the income earned from these savings.

• **Small business expensing:** Section 179 of the tax code allows a sole proprietor, partnership or corporation to fully expense tangible property in the year it is purchased. In 2006, small businesses can immediately expense up to \$108,000 in capital expenditures with an overall investment limit of \$430,000. The deduction was scheduled to shrink to only \$25,000 after 2007, but TIPRA extends the higher amount through 2009.

Property eligible for immediate expensing rather than depreciation includes machinery and equipment, furniture and fixtures, most storage facilities, and single-purpose agricultural or horticultural structures. ■

In My Opinion . . .

Robert J. Cole, Jr., CLU, ChFC, CASL, CFP®

Fire Circle Season...

As I write this column, golf and tennis season has evolved into my favorite time of the year...hiking season. The woods of Kentucky are a place of wonder from mid-October to late November. At the start of the season, brilliant colors make the autumn leaves a work of art. By the last hike, the leaves have fallen and opened up grand vistas that go on for miles.

The first event of the season is the Lincoln Days Festival in my wife’s (and Old Abe’s) hometown of Hodgenville, Kentucky. After attending the events that honor our former president, both of our families gather at the family farm. My family brings tents and we camp out. The first Fire Circle takes place that evening.

The second Ceremony happens with just my family. By now, everyone has spent one night outdoors. Gear issues have been worked on, and we move to a slightly more primitive setting. We eat our dinner outdoors and enjoy the warmth that the fire provides. We also take a “mid-night” hike (usually around 8pm!) to look at the stars, and the kids test their courage against the darkness of the forest.

By now the nights have turned much cooler, and backpacking season begins. This year I took three hikes totaling some twenty miles. Each trip was attended by different groups of friends and there was a Fire Circle every night. These back country fires require that we spend the afternoon gathering wood. These events were further supported by an occasional “tug” on a bottle of single barrel Kentucky Bourbon. We all affectionately refer to these late night conversations as “telling lies” . . . as the stories get bigger and bigger as the night goes on. But there is no mistaking the fact that the bonds between friends are strengthened and mutual understanding grows. A real sense of belonging evolves from these conversations and one gains a sense that our contributions matter.

In the book, *Claiming Your Place at the Fire*, authors Richard Leider and David Shapiro make a case for the Fire Circle Ceremony as a lost tribal tradition that served the role of passing the culture between generations. The primal environment serves as a precipitant for conversations, usually in the form of stories, where the younger members learn their heritage. Their premise is that anyone over age fifty is a “New Elder”. The people who accept this role have a wise voice to offer - from life experiences, reflection, and choice. They are sources of wisdom. Their manifesto is growing “whole” not “old”. They never stop reinventing themselves. They further suggest accepting the biology of aging, but rejecting the psychology of aging. The community sense grows to recognize that our actions do make a difference. According to Leider and Shapiro, “We feel a need to be around the fire and hear what those who have claimed their place have to say. “

What does all this have to do with Life Planning? Well, first of all, backpacking is the ultimate test in planning. If you take what you don’t need, you must carry it. If you don’t take what you need, you could be in trouble. The point is that you must visualize your needs then gather the appropriate resources. You also must keep an eye on Mother Nature, because the weather will dictate a great deal of your needs. Without these preparations, the Ceremony might be one of survival. This is exactly like the financial planning process, where you visualize goals and then allocate resources to those goals. You must also adjust those allocations for circumstantial changes that always occur. Failure to do so will almost always have unpleasant consequences.

Finally, successful aging should recognize the role that you have to play as a “New Elder”. This role will require time and effort. There will be discomfort as your communities evolve, but it will be overshadowed by the personal growth for all of those who hang in there and see the Ceremony through to the end. What you are looking for in life is probably all around you, but you may need help in seeing it. It is up to each of us to find that help and focus on those things or people that support and renew us. A campfire is an excellent place to start that process.

Until next time, that’s my opinion.

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