

Financial *focus*

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When it comes to giving children allowances:

- Set parameters. Discuss with your children what they may use the money for and how much should be saved.
- Make allowance day a routine, like payday. Give the same amount on the same day each week.
- Consider “raises” for children who manage money well.

Take It to the Bank

Piggy banks are a great way to start teaching children to save money but opening a savings account in a “real” bank introduces them to the concepts of earning interest and the power of compounding.

While children might want to spend all their allowance now, encourage them to divide it up, allowing them to spend some immediately, while insisting they save some toward things they really want but can't afford right away. Writing down each goal and the amount that must be saved each week toward it will help children learn the difference between short-term and long-term goals. As an incentive, you might offer to match whatever children save toward their long-term goals.

Shopping Sense

Television commercials and peer pressure tempt children to spend money, but they need guidance when it comes to making good buying decisions. Teach children how to compare items by price and quality. When you're at the grocery store, for example, explain why you might buy a generic cereal instead of a name brand.

By explaining that you won't buy them something every time you go to a store, you can lead children into thinking carefully about the purchases they do want to make. Then, consider setting aside one day a month when you will take children shopping for themselves. This encourages them to save for something they really want rather than buying on impulse. Suggest they put “big-ticket” items on a birthday or holiday list.

Don't be afraid to let children make mistakes. If a toy breaks easily or doesn't turn out to be as much fun as seen on TV, eventually children will learn to make good choices even when you're not there to give them advice.

Earning and Handling Income

Older children may earn income from part-time jobs after school or on weekends. Particularly if this money supplements any allowance you give them, wages enable children to get a greater taste of financial independence. With greater financial independence should come greater fiscal responsibility. Older children

Teach Your Children Well: Basic Financial Education

By Mike Skolnick, CPA/PFS, RICP®
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Even before your children can count, they already know something about money: it's what you give the ice cream man to get a cone or put in the slot to ride the rocket ship at the grocery store. As soon as your children begin to handle money, start teaching them how to handle it wisely.

Making Allowances

Giving children allowances is a good way to begin teaching them how to save money and budget for the things they want. How much you give them depends in part on what you expect them to buy with it and how much you want them to save.

Some parents expect children to earn their allowance by doing household chores, while others attach no strings to the purse and expect children to pitch in simply because they live in the household. A compromise might be to give children small allowances coupled with opportunities to earn extra money by doing chores that fall outside their normal household responsibilities.

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Potential Tax Changes Under a Biden Administration

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It is difficult to predict what will happen in this November's presidential and congressional elections, but we will review proposals of Former Vice President Biden and his camp ("Biden") in this brief overview. President Trump will likely reveal his party's proposals in the coming weeks, and we can review those at such time.

While there are obviously more details on this potential legislation, we are including a few highlights of the tax proposals.

- 1. Marginal Tax Rates at the Higher End May Increase.** Biden has proposed increasing the top marginal tax rates to the previously high amounts of 39.6% (pre-TJCA law) from its current level of 37%. As of 2020, the highest rate applies at an income tax base of \$518,401 for single filers and \$622,051 for joint filers.
- 2. Cap on Itemized Deductions.** Biden has proposed a cap on itemized deductions at 28% as well as bringing back the Pease Limitations for itemized deductions. While many taxpayers no longer itemize deductions in light of the tax legislation which significantly increased the standard deduction amount, this law will still impact many taxpayers—especially those in higher income tax brackets. This proposed legislation basically provides that even if you are in the top tax bracket of 39.6% (proposed), you would only get a deduction of 28% of the itemized deductions (and assuming no other phaseouts).
- 3. Impose the 12.4% Social Security Tax on Earnings Over \$400,000.** Currently, the Social Security Tax ("SS Tax") is capped on wages up to \$137,400, but the Biden administration has proposed extending the SS Tax for earnings in excess of \$400,000. While the Medicare Tax of 2.9% applies to an unlimited amount of wages, the higher SS Tax of 12.4% is capped as noted (the employee's share of this tax is one-half of this amount or 6.2%). Thus, there would be a donut in which the SS Tax would not apply (between the lower limit of \$137,400 and the upper limit of \$400,000).
- 4. Increase Capital Gains and Dividends Tax Rates for High Income Individuals.** Biden has proposed increasing the capital gains tax rates and dividends tax rates to 39.6% for those with income over \$1,000,000. Currently, such rates are 20% for those with significant income (and 15% for others) plus the 3.8% net investment income tax, when applicable. While this will not apply to many taxpayers, this is a significant increase. Rather than paying a top rate of 23.8%, ultra-high income tax payers may now be faced with a federal capital gain and dividend tax rate of 43.4% (39.6% + 3.8%).
- 5. Phase-Out of the Qualified Business Income Tax Deduction.** Currently, owners of pass-through entities (sole proprietorships, LLCs, S corporations) may be able deduct 20% of their qualified income ("Qualified Business Income") through 2025. While there are more detailed rules on when this deduction can be made and certain high-income taxpayers may already be phased out in taking this deduction, Biden would eliminate that deduction for all of those taxpayers with income over \$400,000.
- 6. Expand the First-Time Homebuyer Tax Credit.** Biden has proposed reinstating and increasing the first-time homebuyer tax credit of \$15,000. While all of the details have not been offered, it will be interesting to see whether the details of any proposed legislation will correspond to a similar credit passed in 2008 (and subsequently expired).
- 7. Estate and Transfer Tax.** Biden—as documented in the *Biden-Sanders Unity Task Force Recommendations* released in July, 2020—has suggested that estate taxes should "return to their historical norm". This may mean reducing the transfer tax exemption—the amount one can pass to heirs tax free—to \$3.5 million as such amount ties with recent proposals by the Democrat party. Currently, the exemption is a whopping \$11.58 million (due to the 2017 Tax Cuts and Jobs Act). Since the Democrats referenced the desire to "address the extreme concentrations of income and wealth inequality", changes to the estate tax laws in some form should not be ruled out.
- 8. Step-Up in Basis.** Related to the estate tax is the step-up in basis rule. Current law allows for heirs to receive a step-up in basis for assets owned or deemed owned at death. This rule does not apply to certain assets such as IRAs, 401(k)s, or annuities. Biden and prior administrations have proposed eliminating such step-up rule, and thus potentially increasing capital gains for the heirs in certain situations.
- 9. Other Changes.** Other parts of Biden's proposals include increasing the tax rate that C Corporations pay to 28% (from 21%), expanding benefits for businesses that create new 401(k) plans, and limiting the ability to do like-kind exchanges.



As with all potential legislation, nothing is certain until it is passed. More significantly, it is still uncertain what party—if any—will prevail come November. Despite this uncertainty, it is critical to stay abreast of potential tax law changes and evaluate how it relates to your situation. Don't let the tax laws control your choices but do consider taxes as one factor in your decision-making process. Of course, if you need help navigating taxes and your overall finances, please do not hesitate to reach out to a financial planner to begin the conversation.



Contract Worker or Employee: An Essential Distinction

By Anne McFarland, CFP®
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Change and flexibility are the name of the game during the current pandemic and this is especially true for parents with children as they navigate childcare, education, and careers. The July 20th issue of the *Wall Street Journal* contained an article titled: “I’m a Parent. And a Bad Teacher. All I Do Is Panic About School: September is coming—and too many children and educators don’t have a plan”. While somewhat tongue-in-cheek, it hits a chord for many parents—and especially single parents who do not have a built-in support network.

What is a parent to do? Private educators. Nanny shares. Learning Pods. These options are getting a lot of attention as parents work to figure out which works best for their family and budget. The decision about which to pursue is difficult enough without throwing into the mix how best to pay these workers—whether they are in-person or remote—as independent contractors reported on a 1099 or employees reported on a W-2.

While not exhaustive, here are some of the aspects the Internal Revenue Service (IRS) and Department of Labor (DOL) review to determine whether an individual is a contractor or an employee. You can use this table to help evaluate your specific situation. Circle the X in the appropriate column to help determine whether you have hired or are hiring a contractor or an employee.

	Contractor (1099)	Employee (W-2)
Family controls the schedule		✓
Worker controls the schedule	✓	
Family has expectations for the duties the individual will perform		✓
Worker has expectations for the duties they will perform	✓	
Family hires a back-up person if the individual is not available		✓
Worker hires a back-up person if they are not available	✓	
Is the job permanent until the individual is laid off, let go, or quits?		✓
Is there a specific end date for the work to be done?	✓	
Is the individual dependent on this work?		✓
Does the individual have other projects or work in place so losing this position is not critical to them earning a living?	✓	

Why is this important to you and the person you work with? Taxes!

Employees, with wages reported on a W-2, pay half of the self-employment taxes and the employer pays half. The employer also contributes to state unemployment insurance tax, which protects employees who earn more than \$1,000 per year. The calculating, collecting, reporting, and paying of all of these taxes is complex and we strongly recommend hiring a payroll provider or asking the individual to become an employee of an agency which handles all of this rather than assuming this risk yourself.

Contractors, with wages reported on a 1099, pay all of the self-employment tax and are typically not entitled to unemployment benefits (this

is slightly different in 2020 with the CARES Act providing unemployment benefits for self-employed individuals).

While it may be tempting to pay the person by 1099 and let them figure everything out, the IRS and Department of Labor work together on cases concerning employee vs. contractor classifications. Paying an employee as a contractor is considered tax evasion. Paying a person as an employee can help them qualify for a loan for a home or a car more easily than as a 1099 employee.

You can find more detailed information on the IRS website. If you have questions about whether you are hiring or have hired a W-2 employee or a contractor, please reach out to a financial planner to help you decide and then work through how best to pay the individual to minimize the risk to you.

Teach Your Children: (Continued from page 1)

may have more expenses, and their extra income can be used to cover at least some of those expenses. To ensure that they’ll have enough to make ends meet, help them prepare a budget.

To develop a balanced budget, children should first list all their income. Next, they should list routine expenses, such as pizza with friends, money for movies, or gas for the car (don’t include things you will pay for). Finally, subtract the expenses from the income. If they’ll be in the black, you can encourage further saving or contributions to their favorite charity. If the results show that your children will be in the red, however, you’ll need to come up with a plan to address the shortfall.

- To help children learn about budgeting:
- Devise a system for keeping track of what’s spent.
 - Categorize expenses as needs (unavoidable) and wants (can be cut).
 - Suggest ways to increase income and/or reduce expenses.

The Future Is Now

Teenagers should be ready to focus on saving for larger goals (e.g., a new computer or a car) and longer-term goals (e.g., college, an apartment). And while bank accounts may still be the primary savings vehicles for them, you might also want to consider introducing your teenagers to the principles of investing.

To do this, open investment accounts for them (if they’re minors, these must be custodial accounts). Look for accounts that can be opened with low initial contributions at institutions that supply educational materials about basic investment terms and concepts.

Helping older children learn about topics such as risk tolerance, time horizons, market volatility, and asset diversification may predispose them to take charge of their financial future.

The ACP Bond Ladder – How Sensitive to External Factors?

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One of the cornerstones of the ACP strategy is a bond ladder of US Treasury bonds up to 15 years into the future. Though not required, the Treasury bonds commonly used are “zero-coupon” bonds, so-called because they pay zero coupon interest until maturity. They are referred to as Treasury “Strips” because the coupon payments have been stripped from the bond. When the bond comes due on its maturity date, the full face value of the bond is paid.

US Treasury bonds are usually used because they are considered to be the safest investments on the planet. The face value will always be paid because the Treasury, like no other government entity, has the right to print the money and pay it. And because the US is not only the largest but considered the most stable and sophisticated economy on earth, these bonds are the most liquid domestically and internationally. Other types of government bonds can be used for the bond ladder, but no investment is safer or more readily convertible to cash if an emergency arises than US Treasury bonds.

The 15-year time horizon was initiated by ACP founder Bert Whitehead. He observed that the stock market, as measured by the S&P 500, never suffered a loss over any 15-year period or longer since 1927. Further research by Asset Dedication revealed that, even at their worst, stocks provided a higher return than bonds so long as the investment period was 15 years or longer. Neither observation mandates 15 years—ladders can be shorter, of course—but they do suggest that there is no reason to extend beyond 15 years.

Sensitivity Analysis and Elasticities

Regarding the ladders, questions sometimes arise such as, how sensitive is the cost of the bond ladder to changes in interest rates? How about changes for inflation, or the ladder’s time horizon, or other factors? Think of these factors as levers that can be pulled in order to change the cost of the bond allocation. Some of the factors have a bigger impact when you pull them.

These types of queries are answered by what researchers call “sensitivity analysis.” It is a measure of responsiveness that tests how sensitive the outcome is to changes in the original values used to build a complicated set of calculations. For example, if a 1% increase in the price of product causes the quantity sold to decline by more than 1%, the responsiveness of quantity to price is referred to as “elastic.” If less, “inelastic.” An exact 1% change would be “unitary” elasticity.

A recent research project applying sensitivity analysis to ACP’s strip ladders led to some interesting results, summarized here.

1. **Cost of Ladder to Total Cash Flows:** To generate \$40,000 per year over 10 years with no inflation protection (\$400,000 total) would cost about \$386,000 at current interest rates.



Doubling this to \$80,000 per year, would exactly double the cost to \$772,000. Thus, the relationship between income and cost is unitary elasticity. The same is true for 3% inflation protection. If the cash flow increased from \$40,000, increasing at 3% per year, the cost would be \$441,000. \$80,000 per year by 3% each year again would cost exactly double, \$882,000. The doubling is also true for 6% inflation protection.

2. **Inflation:** Protection against inflation is surprisingly inelastic. For 10-year \$40,000 ladders, the cost of 3% inflation protection compared to 0% increases the cost from \$386,000 to \$441,000, only a 14% increase. For 6%, the cost is \$506,000, only 31% higher. In other words, doubling inflation rate does not double cost—it is inelastic with respect to inflation. For 15-year ladders, the costs increase 23% for 3%, 53% for 6%—higher but still inelastic.
3. **Length of Ladder Time Horizon:** This elasticity depends on the inflation protection. A ladder covering 10 years allowing for 0% inflations costs 1.95 times the cost of one covering five years, and one covering 20 years is 1.86 times as one covering 10 years, meaning the response is slightly inelastic. But for 3% inflation the multiples are 2.10X and 2.16X respectively, and for 6%, 2.27X and 2.54X respectively, so the response is elastic—doubling the time horizon more than doubles the cost when inflation is included.
4. **Higher Interest Rates:** Rates on treasuries have been at historic lows recently compared to the past. If rates increased, the cost of the bond ladder would decrease—but not by much. An increase of one percentage point from their current levels (which would be more than double for Strips, which are currently yielding slightly less than 1% for maturities under 10 years) would lower the cost of a 10-year ladder by only about 6% (for a 15-year ladder, about 8%). This inelastic sensitivity also applies to 0%, 3%, and even 6% inflation protection.
5. **Other Government Bonds and CDs:** All of the above apply to Treasury Strips. But other federal government agencies also issue bonds, such as the Tennessee Valley Authority, the Federal Home Loan Bank, etc. These “agency” bonds are considered nearly as safe as treasuries but are not quite as liquid because they are traded much less internationally. As a result, they pay slightly higher interest rates (they have a “liquidity premium”). CDs, of course, are guaranteed. Calculations become more difficult than with Strips because these bonds usually come with coupons and payments must be factored in along with the face value redemptions in building the ladder of cash flows. The cost of equivalent ladders is generally about 1% less than treasuries for 10-year ladders (about 3% less for 15-year ladders), so the response is inelastic.

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