



# 360 Perspectives

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## Key Economic Indicators and What They Mean

Late last year, members of the Federal Reserve Board's Open Markets Committee (FOMC) outlined some of the indicators they're watching to help determine when the economy might be stable enough to handle higher interest rates. Here's a primer on some of those indicators and why they're important.



*Gross Domestic Product (GDP)* indicates whether the economy is growing, shrinking, or stagnant. It represents the value of all goods and services produced in the United States, minus the value of all imports. This is the broadest measure of economic health.

Inflation represents increases in the cost of goods and services. The *Consumer Price Index (CPI)* represents increased costs for everyday expenditures such as housing, transportation, food, energy, and clothing. In addition to serving as an inflation gauge, CPI affects any payments tied to the cost of living, such as Social Security benefits.

A related measure, so-called core CPI, excludes food and energy prices because they can vary dramatically from month to month. Core CPI is closely watched by the Fed in determining whether and when to raise or lower its target interest rate, which in turn affects bond prices and other interest rates.

Still another inflation yardstick is the *Producer Price Index (PPI)*, which reflects prices at the wholesale level. If prices are rising for items used to manufacture a product, manufacturers and wholesalers may pass increased costs on to retailers and/or consumers. As a result, increases in the PPI can be an indicator of potential future inflation at the consumer level.

*Unemployment and payroll statistics* may seem similar, but they indicate slightly different things. The unemployment percentage usually

quoted in news headlines is based on a Bureau of Labor Statistics (BLS) survey of households. However, it doesn't include people who are working part-time involuntarily, or so-called "discouraged workers" who haven't been able to find a job and have given up looking. The BLS payroll figure uses corporate job records to show whether employers are creating or shedding jobs.

The unemployment rate is traditionally considered a lagging economic indicator, because an increase in jobs typically shows up only after other economic indicators, such as business inventories and unused manufacturing capacity, have begun to show signs of health. However, some economists argue that because the economy has relied heavily for many years on consumer spending, unemployment may now be more of a leading indicator than in the past.

*Personal incomes* as measured by the Commerce Department reflect not only paychecks but corporate and government benefits, pension checks, rental income, dividends, and interest payments; the data can give hints about future spending. *Personal consumption expenditures (PCE)* data show actual consumer spending on goods and services. As with core CPI, the Fed relies on PCE when setting its target interest rate.

*Industrial production* figures indicate whether factories are producing as much as they're capable of. When resource utilization is low, it suggests that factories are unlikely to experience near-term inventory shortages that could spark inflation. Somewhat related are *durable goods orders*, an indicator of inventory level and business investment in equipment. Also of interest are housing starts, new building permits (which hint at future construction), and new and existing home sales and prices.

These are only some of the data points to watch as guideposts in the months ahead.

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Key Economic Indicators and What They Mean

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## Got Stock? The Long and Short of Capital Gains

If you buy or sell shares of stock, you need to be familiar with the rules that govern the way capital gains are taxed. That's because the amount you owe in tax can depend on a number of factors, including the length of time you hold the shares and the federal income tax bracket you're in. Here are the basics.



### Basis and holding period

"Basis" refers to your investment in the shares of stock you hold. Generally, your basis is the amount you paid for the stock, plus any commissions you paid to purchase the shares. (Note, however, that special rules apply if you received the stock as a gift or as part of an inheritance.) If you sell a share of stock and the sales price--less any commission--is more than your basis, you have a *gain*; if the amount you receive is less than your basis, you have a *loss*.

Your holding period is generally the length of time that you hold a share of stock before you sell or exchange it. If you hold a share of stock for a year or less before selling it, any gain you have is *short-term* capital gain. If you sell a share of stock after holding it for more than a year, any gain is *long-term* capital gain. Your holding period typically starts on the trade date the share is purchased, and ends on the trade date it's sold.

### Short-term capital gain

Short-term capital gain is treated as ordinary income, just like interest on your savings account or wages from your employer. It's added in with all of your other income, and the amount of federal income tax you owe depends on the federal marginal income tax bracket you're in. For example, if you're in the top tax bracket in 2010, you'll pay tax on ordinary income at a maximum rate of 35%.

### Long-term capital gain

If you sell shares of stock that you've held for more than a year, any gain is long-term capital gain, and special maximum tax rates apply. If you're in the 10% or the 15% marginal income tax bracket in 2010, you'll pay no federal income tax on long-term capital gains (a "0% tax rate" applies). So, for single individuals with taxable income of \$34,000 or less (\$68,000 for married individuals filing jointly), long-term capital gains are federal income tax-free in 2010.

For those who aren't in the lowest two federal income tax brackets (i.e., those in the 25%, 28%, 33%, and 35% brackets), a 15%

maximum tax rate generally applies to long-term capital gains. There are limited cases, however, when individuals in the higher tax brackets can still benefit from the 0% tax rate.

For example, a retired couple with taxable income of \$60,000 would be in the 15% marginal income tax bracket in 2010 if they file jointly (the bracket covers married couples with taxable income less than or equal to \$68,000). The couple sells stock, resulting in a long-term capital gain of \$40,000. This increases their taxable income to \$100,000, placing them in the 25% marginal income tax bracket. In this situation, they would pay no federal tax on the first \$8,000 of long-term capital gain, and the maximum 15% rate would apply to the remaining \$32,000 in gain.

### Offsetting gains with losses

Any capital losses that you may have realized during the year can offset some or all of your capital gain. If your losses offset all capital gains, any excess capital loss can be applied against up to \$3,000 of ordinary income (\$1,500 for married individuals who file separately), and any unused capital loss can be carried forward to future years.

### Big exception: retirement plans, IRAs

All of this assumes your stock is not being held in a tax-advantaged retirement account like a 401(k) plan or IRA. Special tax rules apply to investments, including stock, held within these plans. If you sell shares of stock within one of these plans, there's no immediate tax consequence. Instead, you'll generally pay federal income tax when you take withdrawals from the plan, and any income will be considered ordinary income--even if the earnings are attributable to capital gains. (Certain Roth retirement plans and Roth IRAs provide for tax-free treatment of qualified withdrawals.)

### Uncertainty in 2011

The special federal income tax rates that currently apply to long-term capital gains expire at the end of 2010. Absent new legislation, in 2011, individuals in the 15% tax bracket (under current law the 10% bracket disappears in 2011) will pay tax on long-term capital gain at a rate of 10%. For everyone else, a 20% rate will generally apply. Special rules (and slightly lower rates) will apply for qualifying property held five years or more.

### Small business stock

*Special rules apply to qualified small business stock. Generally, a portion of any gain realized upon the sale of qualified small business stock held for more than 5 years can be excluded from income. The portion of the gain that is not excluded from income is generally taxed at a maximum rate of 28%. For additional information, see IRS Publication 550.*

## 10 Financial Terms Everyone Should Know

Understanding financial matters can be difficult because of the jargon used. Becoming familiar with these ten financial terms may help make your financial picture clearer.

### 1. Time value of money

The time value of money is the concept that money on hand today is worth more than the same amount of money in the future because the money today can be invested to earn interest. *Why is it important?* Understanding that money today is worth more than the same amount in the future can help you evaluate and compare investments that offer returns at different times.

### 2. Market volatility

Market volatility measures the rate at which the price of a security moves up and down. If the price of a security historically changes rapidly over a short period of time, its volatility is high. Conversely, if the price of a security rarely changes, its volatility is low. *Why is it important?* Understanding volatility can help you evaluate whether a particular investment is suited to your investing style and risk tolerance.

### 3. Inflation

Inflation reflects any overall upward movement in the price of goods and services in the economy. *Why is it important?* Because inflation generally pushes the cost of goods and services higher, any estimate of how much you'll need in the future--for example, how much you'll need to save for retirement-- should take into account the potential impact of inflation.

### 4. Asset allocation

This strategy means spreading investments over a variety of asset categories, such as equities, cash, bonds, etc. *Why is it important?* How you allocate your assets depends on a number of factors, including your risk tolerance and your desired return. Diversifying your investments over asset classes can potentially help you manage risk and volatility.

### 5. Net worth

Net worth is what your total holdings are worth after subtracting all of your financial obligations. *Why is it important?* Your net worth will probably fund most of your retirement years. Therefore, the faster and bigger your net worth grows, the earlier and more comfortably you will be able to retire. Once retired, preserving your net worth to last through your retirement years is your goal.

### 6. Five C's of credit

These are character, capacity, capital, collateral, and conditions. They're the primary elements lenders evaluate to determine whether to make you a loan. *Why is it important?* With a better understanding of how your banker is going to view and assess your creditworthiness, you will be better prepared to deliver appropriate information to obtain the loan you want or get a better interest rate.

### 7. Sustainable withdrawal rate

Sustainable withdrawal rate is the maximum percentage that you can withdraw from an investment portfolio each year to provide income that will last, with reasonable certainty, as long as you need it. *Why is it important?* Your retirement lifestyle will depend not only on your assets and investment choices, but also on how quickly you draw down your retirement portfolio.

### 8. Tax deferral

Tax deferral refers to the opportunity to pay income taxes in the future for investment interest and appreciation earned in the current year. *Why is it important?* Tax-deferred vehicles like IRAs and annuities produce earnings that are not taxed until withdrawn. This allows those earnings to compound, further adding to potential investment growth.

### 9. Risk/return trade-off

This concept holds that, in order to achieve a higher personal investment return, you must be willing to accept greater risk. *Why is it important?* When considering your investments, the goal is investing to get the greatest return for the level of risk you're willing to take, or to minimize the risk involved in trying for a given return.

### 10. Annuity

An annuity is a contract where you pay money to an insurance company in return for the insurer's promise to pay it back, with interest, in the future. *Why is it important?* You can supplement other retirement savings with tax-deferred annuity funds, and you can add to your retirement income with payments from your annuity for a fixed period of time or for the rest of your life.



### Ten more terms to look up

- Equity
- Gross Domestic Product
- Working capital
- Recession
- Triple net lease
- Net income
- Roth IRA
- Earned income
- Debt/equity ratio
- P/E ratio





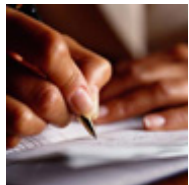
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## Ask the Experts



### What is the premature distribution tax?

Taxable distributions you receive from an IRA, 403(b), 401(k), or qualified employer plan before age 59½ are generally referred to as premature distributions, or early withdrawals.

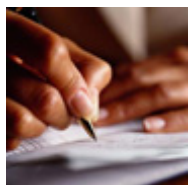
To discourage early withdrawals, they're subject to a 10% federal penalty tax (and possibly a state penalty tax) in addition to any federal and state income taxes. This 10% penalty tax is commonly referred to as the premature distribution tax. Not all distributions before age 59½ are subject to this penalty, however.

Here are the most important exceptions:

- Distributions due to a qualifying disability
- Distributions to your beneficiary after your death
- Distributions up to the amount of your tax-deductible medical expenses
- Distributions made pursuant to a qualified domestic relations order (QDRO)

- Qualified reservist distributions
- Distributions from an IRA (but not an employer plan) to pay first-time homebuyer expenses (up to \$10,000 lifetime)
- Distributions from an IRA (but not an employer plan) to pay qualified higher education expenses
- Distributions from an employer plan (but not an IRA) after separation from service at 55 or older
- Certain distributions from an IRA (but not an employer plan) while you're unemployed up to the amount you paid for health insurance premiums
- Amounts levied by the IRS
- Distributions that qualify as a series of substantially equal periodic payments (SEPPs)

If you must take a distribution from your IRA or employer plan before age 59½, be sure to determine if one of these exceptions applies to you.



### What is the "SEPP" exception to the premature distribution tax?

Taxable distributions you receive from an IRA or 401(k) plan before age 59½ are subject to a 10% early withdrawal penalty unless an exception applies. One important, but sometimes overlooked, exception is for SEPPs--substantially equal periodic payments.

SEPPs are amounts you withdraw from your IRA or employer plan over your lifetime (or life expectancy) or the joint lives (or joint life expectancy) of you and your beneficiary. To avoid the 10% penalty, you must calculate your lifetime payments using one of three IRS-approved distribution methods and take at least one distribution annually.

You can take advantage of the SEPP exception at any age. But payments from an employer plan must begin *after* you separate from service.

Even though SEPPs are initially determined based on lifetime payments, you can change--or even stop--the payments after five years, or after you reach age 59½, whichever is

later. For example, you could start taking SEPPs from your IRA at age 50, without penalty, and then, if you no longer need the funds, reduce (or stop the payments altogether) once you reach age 59½.

But be careful--if you "modify" the payments before the required waiting period ends, the IRS will apply the 10% penalty tax (plus interest) to all taxable payments you received before age 59½ (unless the modification was due to death or disability).

If you have more than one IRA, you can take SEPPs from just one of your IRAs or you can aggregate two or more of your IRAs and calculate the SEPPs from the total balance. You can also use tax-free rollovers to ensure that the IRA(s) that will be the source of your periodic payments contain the exact amount necessary to generate the payment amount you want based on the IRS formulas.

SEPPs can be complicated--especially the modification rules. But taking the time to understand this important financial planning tool can be well worth the effort.