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Post-ATRA: What CPA Financial Planners Need to Know


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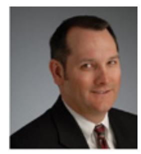
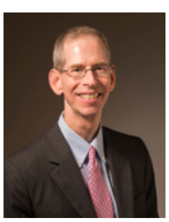

Scott Sprinkle, CPA/PFS, CGMA, CPF®

As part of the Planning After the American Taxpayer Relief Act *series, the Web seminar "Proactive Planning in 2013: What CPA Financial Planners Need to Know to Advise Individual Clients" included panelists Beth Gamel, CPA/PFS, AEP®; Michael E. Kitces, MSFS, MTAX, CFP®; Ted Sarenski, CPA/PFS, CFP®, AEP®; and Scott Sprinkle, CPA/PFS, CGMA, CPF®. Here are the highlights of the discussion, arranged topically. See the sidebar for links on how to obtain the audio recording and presentation materials.*

Whatever you think of the American Tax Relief Act of 2012 (ATRA), at the very least, it was not called "tax simplification."

While explaining this complexity may be an opportunity for CPAs and tax planners, the act presents real challenges for our clients, along with a number of key changes that may come

Chairman's Corner



We are in a time when income tax and estate planning are a critical aspect of your clients' overall personal financial planning. As a CPA working with individuals and families, you are in a great position to expand your practice and create deeper relationships with your clients. The AICPA PFP Division continues to support your efforts with a tremendous array of services, resources, and tools to serve the PFP community.

In this video message, Barry Melancon, AICPA president and CEO, speaks to the broader CPA audience about the opportunities to guide their clients and grow their practices through tax, retirement, and estate planning, and why today's environment makes it the right time to do so, encouraging them to consider the benefits of offering the type of advice and guidance to clients that you, as a PFP section member or CPA/PFS holder, routinely provide to your clients. If you have colleagues or partners who have not embraced the opportunity for firm growth and client and staff retention through the offering of PFP services, encourage them to watch this video.

We thank Barry and the rest of the leadership of the AICPA for their support as we work to reach the broader CPA audience.

Lyle K. Benson Jr., CPA/PFS
Chairman, PFP Executive Committee

WHAT'S INSIDE

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as unpleasant surprises. Although we have to live with new provisions, at least until they are changed again, one thing is certain: under ATRA, taxes are now more closely intertwined with investment planning, retirement cash flow, charitable giving, and estate planning.

In response, forward-looking CPAs and financial planners are taking a multiyear, multiscenario approach when advising individual clients. Traditional planning methods may no longer suffice, particularly for clients in the mid-to-upper ranges of wealth and income. In all cases, planners must bring themselves and their clients up to speed on these key changes.

ATRA Overview

It may be helpful to review the big picture tax considerations under this new law. Although *Planner* has covered all of these points in previous issues, here's a summary:

- Ordinary income tax rates of 10%, 15%, 25%, and 28% reflecting the Bush administration tax cuts were made permanent. Up to set thresholds, 33% and 35% rates remain in effect, while thresholds in the 39.6% bracket start at $400,000 single, $450,000 married filing joint, and $425,000 for head of household. Those threshold amounts will be adjusted for inflation.
- Careful tax and financial planning under these new rates and thresholds will be crucial, given the simultaneous phaseout of exemptions and deductions and new investment tax rules (discussed subsequently in detail). A number of higher-income clients will be exposed to the much-discussed 44.192% rate, which includes the 3.8% Medicare surtax and phaseout of deductions.
- Long-term capital gains and qualified dividend tax rates will increase to 20% for taxpayers in the 39.6% tax bracket, while the minimum remains 15% for those in the middle four tax brackets and 0% for those in the bottom two tax brackets. The qualified dividend treatment is now permanent. The new 3.8% Medicare surtax will also apply to long-term capital gains and qualified dividends for higher income individuals.
- The new law phases out personal exemptions (known as the personal exemption phaseout) and puts limitations on itemized deductions (known as the Pease limitation) on income rising above set threshold amounts. Those adjusted gross income thresholds are $250,000 for single taxpayers, $300,000 for married taxpayers filing jointly, and $275,000 for heads of households. Not many taxpayers are aware of these phaseouts, and because these amounts are indexed for inflation, planning will be more complicated in the future.
- The Economic Growth and Tax Relief Reconciliation Act of 2001 resolved some of the inequalities, including standard deductions and marginal tax brackets relating to married and unmarried taxpayers. Although ATRA extends those provisions, planners should still closely

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examine the advantages of filing jointly versus separately.

- The alternative minimum tax (AMT) has been a late-breaking patch every year for about a decade, and the new law makes these fixes permanent and retroactive. The new AMT exemption amount will be $78,750 for married couples and $50,600 for singles in 2012; in the future, AMT amounts will be indexed for inflation. Although this change settles the annual last-minute AMT question a bit, variations by state and for income ranges will make planning more complex.
- Starting in 2013, a new 3.8% Medicare surtax applies on the unearned income when adjusted gross income (AGI) exceeds $200,000 single and $250,000 married filing jointly. It applies only to the excess over these thresholds if unearned income is greater than the amount of AGI over the threshold. The surtax will essentially raise the marginal tax rates of high income earners to 43.4%. Specific rules define the application of the Medicare surtax for individuals and for estates and trusts. As a rule, the tax applies to taxable interest, dividends, annuity income, rents, royalties, and any passive income. Wages, Social Security and pension income, IRA and 401(k) distributions, active business income, and certain other types of income are exempt.
- Although there has been a lot of press coverage about the Medicare surtax, very few taxpayers are aware of the new 0.9% healthcare surtax on earnings for higher-income households. This new tax applies to wages and self-employment income for single taxpayers earning $200,000 or more and married taxpayers filing jointly who earn $250,000 or more. There is no employer match on this 0.9% tax, and there is no cap. This somewhat "hidden" Medicare tax can pose a big hit for clients with large payouts from stock options or other sources and can cause estimated payment and penalty issues.

General Income Tax Planning Strategies

General income tax planning will certainly change. Traditional rules of thumb, such as instinctive tax deferrals, are no longer relevant. Instead, advisers should adopt a more individualized approach custom tailored to specific client situations. Ideally, plans should provide multiyear and multiscenario projections designed to mitigate the impact of these new laws.

Depending where clients sit relating to the new thresholds, financial planners may suggest a range of strategies, including capital gain harvesting and income acceleration.

Asset location for tax purposes will be more important than ever; planners should work to carefully determine which assets to keep in tax deferred versus taxable accounts. With these higher rates, tools such as annuities, life insurance, and defined benefit plans are worth a closer look. Charitable remainder trusts can be used to manage gains and smooth out income, which can be especially helpful to avoid higher capital gains tax rates and the 3.8% Medicare surtax.

Under previous law, taxpayers had to be at least 59½ or leave their employer to convert a traditional 401(k) to a Roth 401(k), but recent changes removed these restrictions. Some clients may mitigate state or federal income tax liabilities through a Roth conversion, and by projecting expected bracket positions in retirement, it may make sense to convert now.

Roth IRA conversions offer clear benefits, including tax-free compounding and withdrawals for beneficiaries, and more effective funding for bypass trusts, but only if clients don't drive up their current tax rates too far. When considering a conversion, planners should assess tax rate differentials, available funds for living expenses and taxes, and the time horizon for each client. Tax return extensions can be used to move income and assess the impact of Roth conversions.

Estate Planning and Gift Planning

With the new tax laws, we expect to see a shift back toward true estate planning that ensures the plan distributes assets in accordance with the client's wishes. That shift puts a stronger focus on topics such as the naming

ATRA Web Seminars

The audio recording and presentation materials for this Web seminar, "Proactive Planning in 2013: What CPA Financial Planners Need to Know to Advise Individual Clients," are available for download and are part of the series, *Planning After the American Taxpayer Relief Act*. Web seminars in this series include "Top 10 Estate Planning Ideas for 2013," with Robert S. Keebler CPA, MST, AEP® (Distinguished), and Steven J. Oshins, Esq., AEP® (Distinguished), and "Top 10 Income Tax Planning Ideas for 2013" with Keebler, as well as web seminars from Michael Kitces on income and estate planning for the mass affluent (defined as those clients with net worth ranging from $250,000 to $2.5 million), among others. Visit the Web seminar archive for audio recordings and presentation materials, and see page 5 for an article featuring the highlights of the "Income Tax Planning Ideas" Web seminar, as well as information on the "Planning After ATRA and the Medicare Surtax Toolkit."

Since the beginning of 2013, each issue of *Planner* has also featured articles with specifics

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ATRA Web Seminars

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related to ATRA. The May/June issue included "The CPA's Role in Estate Planning After the American Taxpayer Relief Act," March/April featured "Best Planning Ideas for 2013," and January/February included "Planning Implications of the American Taxpayer Relief Act of 2012." Visit the *Planner* Web page for access to all previous issues.

of guardians and beneficiaries, the titling of assets, powers of attorney, the need for trusts, and beneficiary designations for retirement plans.

It may help to review the key permanent estate, gift, and generation-skipping transfer (GST) tax changes under ATRA. Exemptions are set at $5.25 million for 2013, and applicable exclusion amounts will be adjusted for inflation. Spousal portability is permanent, and GST provisions have been extended (though portability does not apply to GST).

What do these changes mean for CPA financial planners? Not surprisingly, these changes will allow CPAs to really shine because most other financial planners don't have the sophisticated tax knowledge needed to advise clients in the post-ATRA world.

Portability, which allows a surviving spouse to use a deceased spouse's estate tax exemption, is a positive, but planners should recognize the limitations on this development. Even nontaxable estates must file an estate tax return that may keep the return open for years. Portability does not apply for GST, nor for any state estate tax purposes, and portability can be overwritten if the client remarries and the second spouse also pre-deceases.

When offering estate and gift planning, CPAs should review existing client documents in great detail. Look for triggers, such as credit shelter trusts and qualified terminable interest property trusts, which may or may not make sense depending on asset totals, portability considerations, and potential differences in state and federal estate tax laws.

In addition, some client circumstances may affect whether it makes sense to retain or distribute income or assets held in a trust. As noted, most situations will now benefit from a more complete, multiyear planning approach.

Life Insurance Strategies

Many reasons to buy traditional life insurance still exist, but in the post-ATRA environment, now may be a good time to re-examine insurance products and strategies. Term, whole life, and no-lapse products may be appropriate for a specific client, albeit with some questions and caveats.

The new tax regime may, for example, open new opportunities for 1035 exchanges. Ultra-high net worth clients may benefit by using some or all of their transfer tax exemption to purchase a single pay policy. Those in the 39.6% bracket and those subject to the 3.8% Medicare surtax might consider the income tax advantages of life insurance.

If held in a trust, should clients adjust policies that exceed their current needs? If held individually, should whole life policies be retained to provide tax-free borrowing or as an asset pool for retirement? If purchased to create liquidity, does the policy make sense with a $10+ million exemption between spouses?

New strategies and products, such as linked or hybrid policies that provide death benefits and long-term care coverage, may be desirable as well.

Practical Ideas for Proactive Planning

CPAs who want to maintain their clients' trust and, of course, long-term business, can view these legislative changes as a real opportunity to demonstrate value and grow their practice. Because of these changes, this is the first time since perhaps the mid-1980s when it is absolutely vital to consider tax ramifications when providing investment planning.

Although it may be fairly easy to discuss strategic issues with high income net worth clients when the numbers are dramatic, major changes are also coming for clients in the $200,000–$500,000 income range. To be proactive, forward-looking CPA financial planners are encouraging face-to-face meetings. They are keeping the lines of communication open and are gaining expertise in the broad outlines and the finer points of ATRA.

Responding to ATRA: Top 10 Income Tax Planning Ideas

By Robert S. Keebler

Tax increases under the American Taxpayer Relief Act (ATRA) and the Patient Protection and Affordable Care Act pose real challenges for taxpayers, their tax preparers, and financial planners. These tax increases include higher capital gains rates, higher ordinary income rates, a 3.8% surtax on unearned income, a 0.9% surtax on earned income, a phaseout of personal exemptions, and limitations on itemized deductions. Together, these new realities demand a long-term approach to income tax planning.

Here are 10 areas for focus and action.

#1—Bracket Management

Starting in 2013, the 10%, 15%, 25%, and 28% rates from the Bush administration tax cuts are made permanent, with 33% and 35% rates for single taxpayers earning up to $400,000 a year and married couples filing jointly up to $450,000 a year. Amounts above the threshold levels are taxed at 39.6%, up from 35% in 2012. The threshold levels are adjusted for inflation.

The tax rate increases from 15% to 20% for taxpayers with long-term capital gain and dividend income above those threshold amounts, and with the 3.8% Medicare surtax, the capital gain rate will actually be 23.8% for many assets. As income rises above other threshold amounts, there will be a phaseout of personal exemptions (PEP) and limitations on itemized deductions, commonly known as the Pease limitation. These threshold amounts will also be indexed for inflation.

To optimize bracket management, CPA financial planners should examine issues such as income tax and capital gain rates, refundable and nonrefundable carry forwards, and the need to equalize ordinary income with itemized deductions and exemptions.

#2—Real Estate Reorganizations

If a client owns a business and self-rents a building, a tax-free real estate restructuring can be used to avoid the 3.8% net investment income tax. By reorganizing to use separate limited liability corporations (LLCs) for holding, operations, and real estate, the lease no longer exists for tax purposes and the surtax no longer applies.

Care should be taken to protect assets and to make sure that the activity rises to the level of a trade or business. Planners should also be aware that the standards for determining whether there is a trade or business activity can be subjective.

#3—Charitable Lead Trusts

A charitable lead trust (CLT) is a split interest trust consisting of income interest and a remainder interest. A donor transfers cash, stock, or other assets to the CLT, which pays annual or more frequent payments for life or for a term of years to a charitable beneficiary. At the donor's death or at the end of the trust term, the donor's children receive the residual assets held in the trust.

CLTs are very dynamic strategies and require close attention. Structured as grantor or nongrantor lead trusts, each one offers specific advantages. The nongrantor version, for example, isolates income and reduces tax exposure. While ordinary charitable deductions do not reduce modified adjusted gross income or net investment income, CLTs can be used to reduce the surtax.

#4—Income Shifting

Given the increased tax rates, income shifting may be a key strategy for many high-income clients. It may help to examine the advantages and disadvantages of key transaction options.

Outright gifts are simple and effective, but they offer no asset, spousal, or spendthrift

About the Author
Robert S. Keebler, CPA, MST, AEP (Distinguished), is with Keebler & Associates, LLP, in Green Bay, Wisconsin. He is a 2007 recipient of the prestigious Distinguished Accredited Estate Planners award from the National Association of Estate Planners & Councils. Contact him at robert.keebler@keeblerandassociates.com.

ATRA Resources

This article is based on "Top 10 Income Tax Planning Ideas for 2013," a Web seminar held as part of the series, *Planning After the American Taxpayer Relief Act*. PFP/PFS members may access an audio recording and presentation materials for this Web seminar. Web seminars in this series include "Proactive Planning in 2013: What CPA Financial Planners Need to Know to Advise Individual Clients" and "Top 10 Estate Planning Ideas for 2013," with Robert S. Keebler, CPA, MST, AEP® (Distinguished), and Steven J. Oshins, Esq., AEP® (Distinguished), among others. Visit the Web seminar archive for audio recordings and presentation materials, and see page 1 for an article featuring highlights of the panel discussion for the "Proactive Planning in 2013" Web seminar.

Giving PFP/PFS members the resources they need to educate themselves and work with clients is a top priority for the AICPA's PFP section. Members may access the "Planning After ATRA and The Medicare Surtax Toolkit" with recordings and presentation materials of topical

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protections. LLC and partnership gifts offer clear tax and control benefits, as well as some asset protection, but somewhat less asset protection than a trust. In a perfect world, many advisers would combine a trust with a partnership.

Other strategic transactions can include gifts to nongrantor family trusts, electing small business trusts and qualified Subchapter S trusts, the conversion of grantor trusts to nongrantor trusts, and distributions from existing trusts. Planners should develop a 5- to 15-year projection of income and deductions, analyze the client's permanent tax bracket, and evaluate whether intrabracket transactions will affect surtax, the alternative minimum tax, PEP/Pease, or the overall tax rate.

#5—Roth IRA Conversions

There are a number of reasons to recommend a Roth IRA conversion. This approach can be beneficial for taxpayers who have favorable tax attributes, including charitable deduction carryforwards, investment tax credits, or net operating losses. The suspension of the minimum distribution rules at age 70 ½ gives the Roth IRA holder a real advantage.

Roth conversions are particularly favorable for clients who are able to pay the income tax on the IRA from non-IRA funds. A Roth conversion can also reduce estate tax exposure. When considering Roth IRA conversions, advisers should examine the tax rate differentials between conversion and withdrawal years, the use of outside funds to pay the tax liability, and the need for IRA funds to meet a client's annual living expenses.

#6—Retirement Charitable Remainder Trusts

A retirement charitable remainder trust (CRT) is well suited to clients in a high current tax bracket—those with solid stock gains each year—who expect to be in a lower tax bracket in retirement.

A net income with makeup charitable remainder unitrust allows highly appreciated assets to be sold and the cash to be reinvested without any income tax being imposed. The trust is structured to pay the donor the lesser of the trust's net income or a fixed percentage of the trust's value each year until retirement. If trust income is less than the fixed percentage, the shortfall goes into a makeup account that can be used to the extent trust income exceeds the fixed percentage in the future. During pre-retirement years, the trust assets are invested to produce little income. After retirement, the assets are invested to maximize income, using amounts in the makeup account to augment the fixed percentage payout. At death, or the end of the trust term, remaining assets are donated to the named charity.

Tax planners should evaluate a client's expected future tax brackets, the balance of tax arbitrage, upfront charitable deductions, and the need for a true charitable intent.

#7—Charitable Remainder Trusts

CRTs can be employed to smooth out income, thus reducing or avoiding surtax and incremental capital gains taxes when a taxpayer has a large gain that pushes income above the applicable threshold amount for a given tax year. CRTs are split interest trusts consisting of an income interest that is paid to the donor or a noncharitable beneficiary during the term of the trust and a remainder interest that is paid to the designated charity.

For tax planning purposes, it is important to realize that CRT donors do not realize gains or losses when property is transferred to the trust or when transferred assets are subsequently sold by the trustee. The grantor recognizes income only when distributions are received and the character of the income (for example, ordinary income, capital gain, tax-exempt income, or return of basis) is controlled by the tier rules of IRC Section 664(b).

#8—Income Shifting Charitable Remainder Trusts

This is not an easy technique, but income shifting CRTs allow clients to sprinkle income across a family. A standard CRT can be used to eliminate, reduce, or deter the 3.8% surtax and the 5% incremental capital gains tax, while shifting the incidence of taxation to children, grandchildren, or both.

Using this approach, highly appreciated assets are transferred to a standard CRT in which children or grandchildren are the lead beneficiaries. The children or grandchildren receive annual or more frequent payments for life or for a set term of years. The donor receives an immediate income tax deduction for the present value of the remainder interest. At the end of the trust term, the beneficiary charity receives the residual trust assets.

An income shifting CRT can be used to manage income taxes, gift and estate taxes, and generation skipping taxes.

#9—IRC Section 453

This IRC provision can be important in the sale of real estate or certain types of equipment. IRC Section 453 allows for the deferral of taxation of installment sales with annual limitations of $5 million and $10 million for individuals and married couples, respectively. Under depreciation recapture provisions, gain is generally deferred until the payment occurs, so clients pay taxes only as the money comes in.

The sale from a taxpayer to a nongrantor trust or a child receives a basis increase, and that basis equals the purchase price. A special rule provides that a sale by a related party purchaser within two years after buying property results in realization of the original deferral. Prudence may suggest waiting somewhat longer than the "two-year and a day" limit. When properly executed, this strategy allows clients to spread out any gain and high net value clients to fly under the radar.

#10—Medicare Surtax

Starting in 2013, a new 3.8% Medicare surtax applies to all taxpayers whose income exceeds a set threshold amount. This change effectively raises the marginal income tax rate for affected taxpayers. For example, clients in the 39.6% bracket would now pay a marginal rate of 43.4%.

For individuals, the new surtax is 3.8% multiplied by the lesser of net investment income or any excess of modified adjusted gross income over the threshold amount. There are complex rules governing types of income included or excluded from net investment income.

A number of statutory avenues, created by Congress and not by tax advisers, offer safe ways to reduce net investment income. These include master limited partnerships, qualified dividends, low-turnover index funds, wind and solar investments, profit sharing and defined benefit plans, oil and gas investments, tax exempt bonds, and other strategies.

Opportunities for Client Interaction

I've detailed 10 ideas for planners to focus on with clients. Of course, there are many other areas of concern based on ATRA. Regardless what approach you take to help them understand ATRA and plan for the future, these considerations present a great opportunity for you to meet with your clients and continue to develop an ongoing dialog on planning strategies and other areas. As the old saying goes, we don't know what we don't know, so it's up to you to take the initiative to educate and inform them on these very complex matters.

ATRA Resources

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web seminars, charts provided by Robert S. Keebler, podcasts, and a number of additional tools and resources. In addition, the March/April issue of *Planner* included the article "Best Planning Ideas 2013," with highlights of a panel discussion held at the January 2013 Advanced PFP Conference.

Are you familiar with Forefield Advisor? Available as part of your PFP/PFS membership, many planners use Forefield Advisor ($449 annual value) to educate clients on a number of topics, including charitable trusts and other topics discussed in this article. Forefield Advisor is a Web-based business development, education, and client communication tool that enables planners to deliver current and concise advise to clients. Resources are continuously updated to reflect current legislation and industry trends.

Important Misconceptions About Risk Tolerance

By Tyler D. Nunnally

Having a clearer understanding of how to assess risk tolerance and successfully incorporate the results into your planning process is critical to the quality of your client relationships.

If you misread your clients' risk tolerance, your clients are in danger of being overexposed

About the Author

Tyler D. Nunnally is a consultant to FinaMetrica in the United States. A specialist in behavioral finance and risk tolerance, he is founder and CEO of Upside RISK, a behavioral finance consultancy based in Atlanta, Georgia. Earlier in his career, Tyler was with Oxford Risk Research and Analysis, Ltd., a spin-off consultancy of Oxford University, formed to bring behavioral finance and risk-behavior academic research to the corporate environment. Tyler was responsible for the commercialization of the company's intellectual property. Contact him at tnunnally@upside-risk.com.

or underexposed to risk. Overexposure can lead to a panicked sale in a downturn, while underexposure can result in missed opportunities. Subsequently, by getting it wrong, your practice may experience high rates of client attrition due to dissatisfaction. In the worst case scenario, you'll have angry clients if they feel you forced them to take on too much risk. We saw plenty of evidence of this in the early 2000s following the dot-com bubble and in 2009 during the recession when there were dramatic spikes in the number of Financial Industry Regulatory Authority (FINRA) arbitration cases filed.

Conversely, you can build a strong foundation of trust with your clients when you are able to guide them to make more informed decisions. With a good understanding of risk tolerance, you will be better equipped to help your clients cope with the emotional highs and lows that are an intrinsic part of the investment journey. And, by employing the right tools, you can bring structure, consistency, and the benefits of science to the planning process, while also adhering to your firm's suitability compliance obligations.

What Is Risk Tolerance?

The most common misconceptions about risk tolerance include the following:

- Uncertainty about what risk tolerance actually is
- All risk tolerance questionnaires are the same
- Risk tolerance and risk capacity are the same
- Risk tolerance fluctuates with market volatility

In financial planning, risk tolerance refers to the level of comfort a person has in taking financial risk generally, and with their investments in particular. The key word to consider here is *comfort*. While some people embrace risk, others detest it. There are varying degrees of comfort and discomfort, and these variances can be attributed to behavioral traits all of us share. Moreover, these behavioral traits are crucial because they ultimately drive our investment decisions. As a result, the behavioral aspect of finance and economics should not be overlooked or discounted; doing so would be foolhardy.

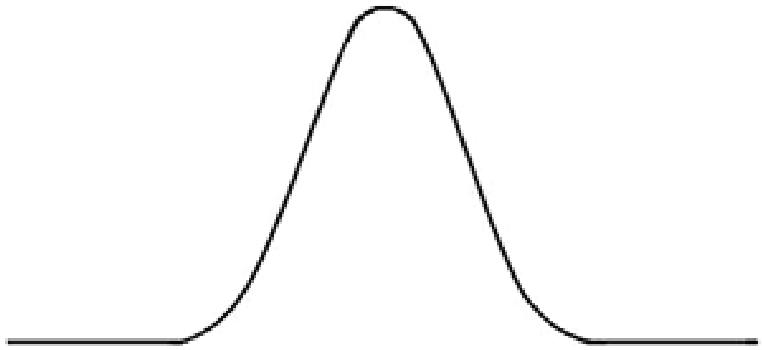
The good news for advisers is that risk tolerance is a measurable, behavioral trait. A well-designed questionnaire will enable you to effectively assess a client's risk tolerance that includes their risk attitudes, values, and preferences. The leading experts in the field will tell you that the best means by which to achieve this is through norms-based psychometric methodologies. Psychometrics, which blends psychology with statistics, provides a point of comparison between a test respondent and others who have also taken the test. Test results are used to segment test respondents and grouped together based on shared common risk preferences and characteristics.

FinaMetrica is a risk profiling system used to gain a more insightful understanding of your clients' financial risk tolerance. In the FinaMetrica risk tolerance test, a person is assigned to one of seven risk groups based on how he or she responded to a series of well-established questions (see figure 1). By determining which risk group a client belongs to, you are better able to make investment recommendations based on the suitability of that investment in relation to the client's comfort in taking risk. For example, if your client, Robert, is in Group 2 with a very low risk tolerance, he is not going to be comfortable with an asset allocation that consists primarily of stocks or other growth assets.

The discomfort that Robert will experience as a consequence of the relatively high volatility of that portfolio is likely to cause him emotional distress that can lead to anxiety, fear, and loss of sleep during down markets. As most of us can attest, these factors also have a tendency to put strains on relationships, including those between clients and their financial advisers.

Note that not all questionnaires are created equal. In fact, the vast majority of the risk tolerance questionnaires used in financial planning have no scientific basis. This concern

Figure 1



Risk Group	1	2	3	4	5	6	7
Score Range	Less than 25	25-34	35-44	45-54	55-64	65-74	75 or more
No. in Group	1%	6%	24%	38%	24%	6%	1%

understandably brings into question their reliance, accuracy, and usability. In Britain, for example, the Financial Services Authority (FSA) regulator evaluated 11 risk tolerance questionnaires for a guidance paper, "Assessing Suitability." The FSA found that 9 of the 11 questionnaires under review were not "fit for purpose."

According to the FSA's findings, some of the most common deficiencies of inadequate risk tolerance questionnaires were poor question and answer options, ineffective scoring, and vagueness. The FSA cautioned that flawed outputs from inadequate risk tolerance questionnaires can cause advisers to select investments that do not match the risk a client is willing and able to take.

Willing Versus Able

It is important to differentiate between risk tolerance, or a person's psychological willingness to take a financial risk, and risk capacity, the financial ability to take that risk. Both act separately as constraints on what your client might otherwise do.

Suppose your client, Stephen, needs the expected return from a 70% stocks portfolio in order to achieve his goals. He also has the risk tolerance for such a portfolio and is therefore willing to take the risk. However, given that there is a 50% chance that the portfolio's actual return will be less than the expected return, Stephen may require additional funds from other sources to reach his goal. If Stephen is not going to be able to fund the goal from other sources, then he is going to run into problems from a risk capacity perspective because it is unlikely that he can reach his goal without them. In this instance, while the 70% stocks portfolio is suitable from a risk tolerance perspective, it is inadequate from a risk capacity perspective.

It is the distinction between Stephen being *willing* to take risk and being *able* to take risk that differentiates risk tolerance from risk capacity. Stephen's willingness to take risk is predicated by his psychological tendencies, but his ability to take risk is dictated by financial realities. The distinction is vital in the planning process because it is a point at which key trade-off decisions are made. By understanding the difference, you can help your clients make informed decisions from the onset of the relationship that carry on throughout the entire course of the plan.

Risk Tolerance Is a Trait—Not a State

It is not uncommon to hear advisers say, "I know what my client's risk tolerance is based on how the market is performing," because advisers see their clients' behavior change as markets rise and fall, and assume that risk tolerance is the sole driver of risk behavior. As a result, advisers believe that a behavioral change must imply a change in risk tolerance. However, substantial new empirical evidence

PFP/PFS Discount on FinaMetrica

The FinaMetrica risk profiling system is a low-cost, quick, and user-friendly way to gain a more insightful understanding (in plain English) of your clients' financial risk tolerance—attitudes, values, motivations, preferences and experiences—and to meet common and statutory law know-the-client and duty-of-care obligations. FinaMetrica's focus is on the psychological factors relevant to financial decision making in terms that are meaningful to individuals and their advisers. PFP/ PFS members receive a 10% discount on FinaMetrica software. For more information on the software, click here. To take advantage of this member benefit, click here.

shows that risk tolerance is stable and that behavioral change is actually driven by changes in perceived market risk.

Figure 2

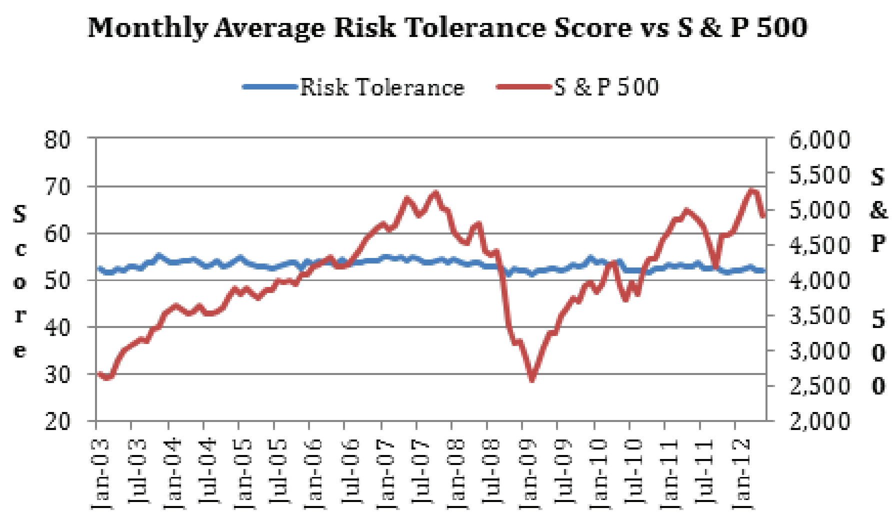


Figure 2 is a simple illustration of the stability of risk tolerance that plots the monthly average risk tolerance score from FinaMetrica's database of more than 500,000 completed risk tolerance tests.

More detailed evidence is contained in FinaMetrica's 2012 white paper, On the Stability of Risk Tolerance. This paper reports six independent academic studies, four of which involved large, heterogeneous samples, conducted over more than a decade. The last of these was a test/retest study in which the same individuals were tested in the 2003–7 bull market and then again in the ensuing bear market. When reporting on this study in July 2010 in the *Journal of Financial Service Professionals*, Michael J. Roszkowski and Geoff Davey found, "Our data suggest that risk tolerance appears relatively stable and was not drastically affected by the economic circumstances of 2008. However, there was clearly a change in people's risk perception, as indicted by their self-assessments."

In a more recent paper of the same test/retest data published at the Social Science Research Network in 2012, Paul Gerrans, Robert Faff, and Neil Hartnett found, "In absolute terms, the change in risk tolerance is low and contrasts with a prevailing view that risk tolerance is an elastic psychological state overly influenced by the pervading market conditions."

The misconception is derived from the belief that risk tolerance is a *state* opposed to a *trait*. Like other behavioral traits and aspects of personality, risk tolerance generally remains stable, irrespective of external influences such as market movements. Research shows that people tend to become less risk tolerant as they get older and that there can be sudden changes in risk tolerance as a result of major life events.

As the market moves, however, what changes is our perception of how risky the market is. As the market swings up, our perception is that the market is less risky. When markets cycle down, our perception is that the market is more risky, bolstered by emotions tied to the fear of loss. To combat these emotions, advisers can educate clients about market risk and manage their expectations through frequent conversations.

Helping Clients Succeed

Clearing up these inconsistencies and misconceptions will help you better manage your relationships with clients. By gaining a better understanding of the science of risk tolerance, you can avoid common pitfalls that often cause friction between advisers and clients. Having satisfied clients will help reduce potential legal liabilities, while also lowering client attrition rates. In addition, satisfied clients are more likely to make the referrals that are needed to continually grow your practice.

New! Web Seminars on Risk Tolerance

The AICPA's PFP section has several opportunities for you to learn more about risk tolerance from Geoff Davey, founder of FinaMetrica. Referred to in this article, Geoff is presenting a series of Web seminars in August:

- "Best Practice Risk Profiling: How Best to Give Investment Advice That Is Suitable with Regard to Risk," Tuesday, August 13, 4:00-5:00 p.m., ET.
- "Managing Your Clients' Risk Tolerance: A Compliance Chore or a Business Development Opportunity?" Tuesday, August 20, 4:00-5:00 p.m., ET.
- "Risk Tolerance Master Class: All the Finer Points about Dealing with Your Clients' Risk Tolerance," Tuesday, August 27, 4:00-5:00 p.m., ET.

Visit the PFP & CPA/PFS Web seminar page to register for these sessions.

In addition, Geoff authored a series of five *Planner* articles in 2010–11; PFP/PFS members still have access to these articles:

- "Managing the Risky Business of Advice"—July/August 2010
- "Using Psychometrics to Assess Risk Tolerance"—September/October 2010
- "Measuring Risk Tolerance: Avoiding Industry-Standard Questionnaires"—November/December 2010
- "Linking Risk Tolerance to Portfolio Risk"—January/February 2011
- "Increasing Cross-Referrals and Profits by Reducing Portfolio Surprises"—March/April 2011

CPA/PFS Profile: Jerry Love

Although Jerry Love, CPA/PFS, may live in what some might consider a small town, any preconceived notion of what "small town" ideals resemble are immediately dismissed once you meet Jerry, learn about his practice, and understand his involvement in the accounting profession. Located in Abilene, Texas, Jerry Love CPA, LLC, offers a full-range of tax and accounting services and, of course, personal financial planning (PFP). Planner recently visited with Jerry to learn more about how he runs his practice, his investment philosophy, and his opinions about continuous learning and growth.

Planner: *Tell us about your PFP practice. What kinds of clients do you represent?*

Jerry Love: I have found that tax clients care more than just how much they owe in tax and/or how they can pay less tax, and are really seeking guidance and advice from their CPA. Over the years, I have found that clients rely on us, as CPAs, to guide them through the many complex aspects of their financial life.

Perhaps the most frequent topic is retirement. It is not uncommon for new clients to tell me they want to retire early, so we start with a conversation about retirement savings, spending patterns, life expectancy, and more. Over time, this discussion expands to a broader context of their financial life and planning with regard to insurance, wills, and financial goals.

Planner: *Do you think it's ever too late to begin planning for retirement?*

Jerry Love: The closer a client is to his or her target retirement age, the less options he or she may have. At that point, retirement planning may be focused mostly on how the person's life is going to play out.

As someone is approaching the contemplated retirement date, I implement what I call a "dress rehearsal," where we figure out what the client's income will be during retirement from all sources, including Social Security and retirement plans. Then, we take a look at what kind of impact their anticipated retirement income would have on their spending for a period of 3-6 months. If the client has any income in excess of budget, we apply it to any outstanding debts, with consumer debt first. If all the debt is paid off, then we add the excess to the person's "emergency fund." This exercise begins to show the client what his retirement budget is going to look like and also gives a gut check as to the budget's sustainability.

Without a doubt, the best strategy is to start saving for retirement at an early age—and be consistent. I think people are beginning to understand that funding their retirement is a personal responsibility and not a benefit that will be provided to them by an employer or the government.

Planner: *How has technology impacted your PFP and estate planning services?*

Jerry Love: Without a doubt, technology has given us tools to do better research and analysis. With software and spreadsheets, we can modify the assumptions of, for example, life expectancy or the amount being saved, and completely recalculate the results to illustrate the expected outcome for the client.

Planner: *How do you market your practice in Abilene? Do you have clients outside of Abilene, and if so, how do you find those prospects?*

Jerry Love: Absolutely I have clients outside of Abilene! In fact, I have tax clients all over Texas, the United States, and overseas. Not all tax clients are financial planning clients, but they could become one. My practice has primarily grown through networking and referrals.

Planner: *In addition to the AICPA's PFS (Personal Financial Specialist), you have obtained quite a few other credentials and designations, including the AICPA's ABV (Accredited in Business Valuation), CFF (Certified in Financial Forensics), CITP (Certified Information Technology Professional), and the new CGMA (Chartered Global Management Accountant), as well as several others. You're also one of only a few who have all five from the AICPA. What motivates you to continually seek out these kinds of learning opportunities, and how have these credentials and designations helped your practice?*

Jerry Love: My clients' needs have led me to continually evaluate my knowledge base and challenge me to a life-long learning path, while the credentials have simply been a by-product.

First, I was motivated to seek the additional training because I wanted to make sure that I have the knowledge to meet my clients' needs. In my tax practice, I quickly found out that clients were asking me many questions about their financial life beyond tax, so I sought out courses to give me a solid foundation in financial planning. As many members of the PFP section know, I'm referring to the PFS.

A similar thing began in relation to having the skill set to determine the value of a small business. I found a frequent need to know the value of a small business for a gift or an estate return, and on occasion, for divorces. So, similarly, I went after the training to give me the knowledge of how to do this. I was also beginning to see a frequency in financial planning for owners of small businesses to know the value of the business, not only for estate planning, but also for retirement planning and exit strategies.

The combination of this training and these credentials allowed me to become an expert witness for a variety of litigation engagements, which then led me to additional training and more credentials.

Planner: *You're very involved in the profession; you currently serve on the National Accreditation Commission, and you are a member of the AICPA Council. In Texas, you were chairman of the Texas Society of CPAs in 2006-7, and received numerous awards and honors for your work. What are the professional and personal rewards you receive from your service?*

Jerry Love: I have been fortunate to serve the profession in numerous ways over the years and hope that I will continue to have more opportunities. Serving in these roles allowed me to meet very talented CPAs from all over the country, enabling me to have people I can call on for guidance, advice, and/or assistance. Through these contacts, I have been able to better serve my clients' needs, with the confidence that I am giving them the best advice possible.

Over the years, I am humbled that many young CPAs sought my assistance for their careers. In some cases, I have been able to give them some guidance that has helped them weather the storm and figure out how to progress from where they are. In other cases, I have helped them discover the alternative that will put them on a path to a more satisfying career. I have also had students come to me as they were getting out of college and moving across the country.

Planner: *Why do you think CPAs who have not yet formalized their PFP practices would benefit from the Fox Financial Planning Network for CPAs™ (FFPN)?*

Jerry Love: Every CPA firm has systems and procedures in place for the services we perform, whether they are formalized and written or informal and less structured. In a small or new firm, those procedures were created based on either prior experience with another firm or borne out of the necessity to have sanity and structure for the flow of work. Most CPAs who are moving into the financial planning arena do not have any prior experience to draw from and they will greatly benefit from the FFPN to help them develop this.

FFPN is like acquiring a "financial planning system" in a box. Deborah Fox and her team will provide you with a flow of how to move your current clients into financial planning engagements, provide workflow and forms to document your work, scripts to use as you formulate your engagement, and checklists to help you perform the services.

Without the FFPN system, a CPA is attempting to set up a financial planning practice using a blank sheet of paper. Why recreate the wheel with trial and error when you can benefit from a successful financial planner with more than 25 years' experience? Furthermore, count the cost of the hours of time it would take you to create these systems, forms, and other items, while being uncertain that you created a truly comprehensive system.

Planner: *What is your advice to a young CPA who is interested in volunteering for the profession but is facing what is perceived as a time crunch?*

Jerry Love: I think that most students today have a solid foundation in college of working in teams on projects. I encourage them to remember the value of that experience. I hope they will find, as I have, that having a strong network of other CPAs who are smarter than me will afford them long-term benefits. Networking can be a key asset in many aspects of their professional career, whether it is getting technical assistance, a client referral, or a foot in the door for a job change.

Planner: *You're a big fan of Jack Welch and recommend several of his books on your website. What concepts do you take away from him with regard to helping clients with their financial planning needs?*

Jerry Love: I'm also a fan of Dave Ramsey and Steven Covey, but simply put, Jack Welch has a track record of success. He is attributed by many as one of the world's most respected corporate leaders. Some say Welch broke the mold and reinvented how to manage a company. He has many memorable quotes; as a planner, I like this one best: *"Giving people self-confidence is by far the most important thing that I can do. Because then they will act."*

Planning Resources From Jerry Love and Fox Financial Planning Network for CPAs™

Over the years, Jerry Love has presented a number of AICPA conference sessions and Web seminars for PFP section members. For example, he participated in the Town Hall Current Ideas Exchange during the May 2013 Conference on Tax Strategies for the High-Income Individuals and the "Improving Your Bottom Line Through Specialization" session during the AICPA Practitioners Symposium, AICPA Tech+ Conference, and 2013 AAM Summit in June 2013.

If you missed either of these conferences, recordings and presentation materials are available in the AICPA's online library. Registered attendees for either of these conferences have complimentary access when they log in through the website (see instructions to access). Those who did not attend can create an account to purchase audio recordings and presentation materials.

Jerry was also part of *From Tax Preparer to Financial Planner: The Road Best Traveled*, a series of Web seminars to help look at financial planning as an additional component to a CPA's tax practice. The audio recordings and presentation materials for this series are available for download.

Fox Financial Planning Network for CPAs™

Fox Financial Planning Network for CPAs™ is a customized version of Deborah Fox's Fox Financial Planning Network to help CPAs generate new revenues and improve their processes in the shortest time possible with the least amount of capital expenditures. This benefit is available to PFP section members, inclusive of CPA/PFS credential holders, and offers three membership levels with deeply discounted pricing that is not available to the public. Visit www.aicpa.org/PFP/FFPN to review program details and access several free supporting documents to help you get started!

PFP News

Recently Released PFP/PFS News & Resources *To Help You Practice Competently & Profitably*

Below is a brief recap of the news, resources, advocacy, and education made available to PFP/PFS members since the past issue of *Planner*. This is just a small snapshot of the many benefits you receive as a PFP/PFS member. Review the core PFP/PFS member benefits provided to help you practice competently and profitably. Provide feedback on the benefits you value most and/or additions and improvements you'd like us to consider.

- Volume 1 of the 2013 edition of *The CPA's Guide to Financial and Estate Planning*
- PFP Executive Committee Releases Exposure Draft on Proposed Statement on Standards in Personal Financial Planning Services

- Video from AICPA CEO on Helping Your Clients Make Sense of a Complex Financial Environment
- Discount on MoneyGuidePro Financial Planning Software
- Whitepaper: *From Client Tax Returns to Value-Added Planning: A Guide for CPAs*
- Article: *Advising Clients in the Current Market Environment*
- June *Inside Information* covering making powerful changes in your practice, and more
- July *Inside Information* covering planning at the end of life, and more
- E-Columns from Bob Veres on investment issues to ponder and "fiduciary day"
- Media Reviews from Bob Veres
- Forefield Resource Center for Retirement Plan Participants
- Forefield Alert: Social Security and Medicare Trustees Reports Highlight Challenges
- Forefield Alert: Signs of a Housing Recovery?
- Forefield Alert: Two Supreme Court Rulings Boost Same-Sex Marriage Rights
- Forefield Alert: Recent Market Volatility
- Forefield Alert: Student Loan Rate Doubles
- Forefield Alert: White House Delays Employer Health Insurance Mandate
- Dynasty Trust State Rankings Chart from Steve Oshins, Esq. AEP (Distinguished)
- Free webcast: *CPA/PFS Perspectives on Growing Your Tax & PFP Business in your Local Market*
- Free webcast: *Advising & Communicating with Clients in the Current Market & Interest Rate Environment*
- Free webcast: *The 3.8% Medicare Surtax & Its Impact on Estates and Trusts*
- Free webcast: *Advertising & SEC Examinations*
- Free webcast: *Investment Tax Planning*
- Free webcast: *Advanced Income Tax Strategies for the Mass Affluent in 2013 and Beyond*
- Free webcast: *Financial Planning and Tax Considerations for Non-Traditional Couples*
- Free webcast: *Estate Planning for the Mass Affluent in 2013 and Beyond*
- Podcast from Bob Keebler on tax & estate planning following the DOMA decision
- Sample client letter on tax impact of same sex marriage ruling
- New Tax Planning Brochures to Inspire Clients to Contact You Year-Round
- Four new topics to discuss with local media added to CPA/PFS Marketing/Media Toolkit
- Scholarship for the 2013 Advanced Estate Planning Conference (July 15-17, Baltimore)
- Leg/Reg updates reminding members to file FBARs by June 30.
- Advocacy: The AICPA represented your interests in Washington by voicing opposition to a weakened fiduciary standard, recommending changes to the Medicare surtax proposed regulations, requesting clarification from the IRS on conversion of disregarded entities to partnerships and urging the IRS to reconsider e-services.

PFP Calendar of Events

Note: PFP section members, including CPA/PFS credential holders, attend Web seminars free without CPE unless otherwise noted or for a discounted price with CPE. View the complete list of Web seminars and registration links.

Event Title	Format/Location	Dates	More Information
Registration links for upcoming ***Web seminars*** *are available on the* ***PFP website****.*			
Defend Your Business Against Hacking, Phishing, and Spoofing Attacks with Bill Winterberg	Online Webcast	August 6, 1:00-2:45 p.m. ET	Free without CPE; Discounted CPE available.
Effective Use of Marketing and Media Resources for CPA/PFS Credential Holders with Jonathan Cox and Susan Josephson	Online Webcast	August 8, 1:00-2:00 p.m. ET	Free without CPE to CPA/PFS credential holders only.
Best Practice Risk Profiling: How Best to Give Investment Advice That Is Suitable with Regard to Risk with Geoff Davey (Part 1 of Series: *Risk Profiling and Tolerance*)	Online Webcast	August 13, 4:00-5:00 p.m. ET	Free without CPE; Discounted CPE available.
Essential Estate Planning Considerations with Steve Siegel (Part 1 of Series: *Planning after ATRA*)	Online Webcast	August 14, 1:00-2:45 p.m. ET	Free without CPE; Discounted CPE available.

Event Title	Format/Location	Dates	More Information
Registration links for upcoming ***Web seminars*** *are available on the* ***PFP website****.*			
Managing Your Clients' Risk Tolerance: A Compliance Chore or a Business Development Opportunity? with Geoff Davey and Michael Goodman (Part 2 of Series: *Risk Profiling and Tolerance*)	Online Webcast	August 20, 4:00-5:00 p.m. ET	Free without CPE; Discounted CPE available.
PFP Power Hour: Making the Most of Your PFP Section Membership with Jean-Luc Bourdon and Ted Sarenski	Online Webcast	August 22, 3:00-4:00 p.m. ET	Free to all; No CPE.
Plan Before You Borrow: What You Should Know about Planning for College Education with Ernie Almonte and Kara Kessinger	Online Webcast	August 26, 1:00-2:00 p.m. ET	Client-oriented webcast is free for anyone to attend. No CPE.
Risk Tolerance Master Class: All the Finer Points about Dealing with Your Clients' Risk Tolerance with Geoff Davey, Lyle Benson, and Chris Benson (Part 3 of Series: *Risk Profiling and Tolerance*)	Online Webcast	August 27, 4:00-5:00 p.m. ET	Free without CPE; Discounted CPE available.
Using a Workflow System and Integrated Technology Solutions to Deliver Consistent Client Services Efficiently & Profitably with Deborah Fox	Online Webcast	September 4, 1:00-1:30 p.m. ET	Anyone may attend this event for free. No CPE.
Using Interns to Begin the Evolution from Solo Financial Advisor to Ensemble Firm with Deborah Fox	Online Webcast	September 5, 2:00-2:30 p.m. ET	Anyone may attend this event for free. No CPE.
How to Attract Clients to Your Financial Advisory Firm by Finding a Niche with Deborah Fox	Online Webcast	September 10, 1:00-1:30 p.m. ET	Anyone may attend this event for free. No CPE.
Portability: A Planning Game-Changer - But Not as Simple as It Appears with Steve Siegel (Part 2 of Series: *Planning after ATRA*)	Online Webcast	September 19, 1:00-2:45 p.m. ET	Free without CPE; Discounted CPE available.
What CPAs Need to Know about Insurance Planning for Individual Clients with Amy Sonstein	Online Webcast	September 25, 1:00-2:45 p.m. ET	Free without CPE; Discounted CPE available.
Why Most Arguments For or Against Active and Passive Investment Management are Wrong with Deborah Fox	Online Webcast	October 17, 1:00-2:15 p.m. ET	Free without CPE; Discounted CPE available.
Strategies for Pre-Retirees and Retirees to Not Outlive Their Money During Times of Below-Normal Market Returns with Deborah Fox	Online Webcast	October 24, 1:00-2:15 p.m. ET	Free without CPE; Discounted CPE available.
Part 3: Business Succession Planning After ATRA with Steve Siegel (Part 3 of Series: *Planning after ATRA*)	Online Webcast	October 31, 1:00-2:45 p.m. ET	Free without CPE; Discounted CPE available.
Taxation of Divorce with Steve Siegel (Part 4 of Series: *Planning after ATRA*)	Online Webcast	November 21, 1:00-2:45 p.m. ET	Free without CPE; Discounted CPE available.
Registration links for upcoming ***conferences*** *are available on the* ***PFP website****.*			
AICPA Sophisticated Tax Planning for Your Wealthy Clients	AICPA Conference Boston, MA	November 18-19, 2013	PFP/PFS members save an additional $100 off the early bird AICPA member price.
AICPA Advanced Personal Financial Planning Conference	AICPA Conference Las Vegas, NV	January 19-22, 2014	PFP/PFS members save an additional $100 off the early bird AICPA member price.
Implementing PFP Services: **Step-by-Step Plans for Success**	AICPA Preconference Workshop Las Vegas, NV	January 18-19, 2014	PFP/PFS members save an additional $100 off the early bird AICPA member price. (Registration link coming soon!)

Is there a cutting edge or hot topic you would like covered in a Web seminar, or have you heard a fantastic speaker we should invite to speak on behalf of AICPA PFP section members? Share your ideas with the PFP team.

The views and opinions expressed in Planner *are those of the authors.*