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Dear friends and clients:

### Virtual Assets

I am following up on my August 23, 2012, report on the astounding advances in communication and the revolution in delivery of information services, especially legal services. But “delivery” is an improper concept for this message involving *virtual reality*. No one can deny that virtual reality is here and ever present. We purchase books, newspapers, magazines, and other products over the internet. Books, music, consumer and commercial products and services are purchased on-line. Many books and articles are stored on e-readers (such as Nook or Kindle) or tablets (such as iPads). Books music, and services are archived by providers without charge. Hundreds of our books reside in the “cloud” or on Amazon’s servers. These are designated as *e-assets*. Books need not be stored on shelves and a stereo “hi-fi” is no longer necessary for enjoying music. Few consumers keep CD’s, videos, or vinyl records in bulky cabinets.

The benefits of this digital “shift” are enormous and valuable. But are these valuable “e-assets” property? What happens to “e-assets” upon the death of the owner? Can we dispose of them by testamentary or gratuitous disposition? If so, how is the disposition accomplished?

Just as information technology has caused a revolution in delivering music and publications, it is also revolutionizing property concepts. Reportedly, some states have already begun fashioning legislation to help answer these questions. Although California often leads the country in legal reform, it has yet to legislate on digital assets and their disposition.

Personal and consumer interests diverge sharply from the interests of Amazon, Google, and other large internet service providers. Amazon contends that the e-books it “sells” are only *licensed*, not *purchased*, and therefore not transferable. But most consumers edit their e-books by highlighting passages, adding notes in the margins, and checking the dictionary definitions of words, just as if it were a hard copy book or periodical arriving in the mailbox or acquired at a bookstore. A consumer can even select which digital dictionary he wishes to use for definitions. These highlights and edits add value and make the publication ours personally. We should be able to transfer these personal assets by intervivos or testamentary disposition.

Inevitably, legislation and litigation will eventually provide answers. In the meantime,

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Wills and Trusts should be modified to identify, gift, or bequeath these assets. It seems prudent to authorize an Executor or Trustee to communicate with various service providers and to properly dispose of "e-assets." For instance, a dispositive instruction might say:

"As of January 1, 2013, I own 136 e-books, purchased from Amazon. This collection is expected to grow. Some of these e-books are archived at Amazon, and are electronically retrievable without cost. I authorize my Executor to take possession of these assets and asset enhancements and deliver them to my designated heirs for their use, benefit, and enjoyment. I also have music stored on iTunes. The collection is growing. I authorize my Executor to take possession of my music, and make disposition as provided herein."

This type of provision can be added by Amendment or Codicil the next time you update your Estate Plan. Of course, our office can help if you would like assistance.

### **Asset Management**

Here are a few well accepted suggestions for asset management in light of recent legislation:

Two new federal laws will effect our income taxes in the long term. Health care reform and the "fiscal cliff" resolution mean new and higher taxes on the wealthiest Americans and extended tax relief for others, but resulted in higher payroll taxes for all wage earners.

To help understand how these laws may affect you, we will discuss five "hypothetical scenarios" to illustrate how to more effectively allocate assets and manage taxes. The scenarios may not match your situation, but they should provide ideas on how you may be able to work toward your financial goals. It's also important to note that the suggestions listed are not the only changes to make but are important in light of the recent tax law changes.

### **Hypothetical Scenario #1: A Young, Married Couple**

Jim and Jane: He's a 30-year-old EMT; she's a 27-year-old retail manager  
Combined salaries: \$85,000  
Liabilities: Student loans, credit cards  
Financial goals: Save for a home, invest for retirement, and pay off debt

Jim and Jane need a disciplined approach toward finances and a plan to address their goals. They've been saving in bank accounts plus 10% of Jim's salary in his 401(k) Plan. Jim

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received a bonus during a recent natural disaster and deposited the additional \$15,000 into their savings account. Jane has not saved anything for retirement.

**Jim and Jane should:**

- **Adjust their budget.** The new laws didn't extend the payroll tax holiday. Social Security taxes have increased from 4.2% back to 6.2%. This means Jim and Jane will need to adjust their spending to account for a \$1,700 reduction in annual pay – and adjustment of \$142 per month.
- **Pay off debt.** They should consider paying off their credit card balance if it has a high interest rate, and making additional payments toward Jane's student loan. They can continue to deduct up to \$2,500 in interest from Jane's student loan based on their joint income level.
- **Consider investing with an eye on taxes.** The tax law changes did not change Jim's and Jane's tax bracket, and while the act increases taxes on capital gains and dividends from 15% to 20% for some taxpayers, Jim and Jane are not affected. To reduce current taxes and address their retirement planning concerns, Jim could increase his 401(k) Plan contribution. If future taxes are more of a concern, a Roth IRA should be considered.

**Hypothetical Scenario #2: A Married Couple with Children**

John and Judy: He's a 37-year-old occupational therapist technician, and she's a 35-year-old marketing specialist

Children: Ages 8 and 4

Combined salaries: \$150,000

Liabilities: credit card, car loan

Financial goals: Recover from recent stock market declines, make appropriate retirement account allocation, save for children's college, and save for a house.

Currently, 50% of their 401(k) is in a target fund and 50% is in cash. John and Judy intend to return to U.S. equities once they feel that the political and economic environment improves. Before 2008, they owned a few stocks and mutual funds they had self-selected, but sold them after the markets plummeted and moved the money into savings.

**John and Judy should:**

- **Take advantage of child-care deductions and child tax credits.** Depending upon their income and child-care expenses, John and Judy could qualify for a tax credit of up to 35% of these expenses. These laws were continued as part of the recent tax legislation.
- **Consider opening a 529 college savings account.** John and Judy can open and fund a

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529 college savings plan for their children. These accounts can be opened for as little as \$50, and investment choices include age-based portfolios that update automatically to a lower risk mix as the children get closer to college.

- **Consider investing the cash in their 401(k) retirement account.** John's and Judy's retirement accounts shouldn't be accessed for at least 30 years. This means the short-term volatility associated with a diversified portfolio should not serve as the benchmark for investing success. Their 401(k) investment should be part of a sound retirement plan that takes into account their goals, investment objectives, and risk tolerance.

### **Hypothetical Scenario #3: A Financially Secure Couple**

Fred and Frannie: He's a 45-year-old petroleum engineer; she's a 40-year-old college professor  
Combined salaries and income: \$325,000 (includes Fred's and Frannie's salaries plus investment income)

Liabilities: None

Financial goals: Prepare for a future market crash

From September 2008 to March 2009, Fred and Frannie watched the financial markets and their accounts drop by more than 47% before reluctantly recognizing their losses and reinvesting in money markets and bond funds. Now, the new tax laws, 3 1/2 years of high unemployment, a still-declining housing market and looming debt-ceiling discussions have them convinced another severe market downturn is inevitable. Given this, they want to continue their "wait-and-see" approach with their retirement portfolio.

### **Fred and Frannie should**

- **Consider reallocating 401(k) and IRA accounts into diversified portfolios.** Fred's and Frannie's retirement accounts won't be accessed for at least 20 years. Short-term volatility associated with a diversified portfolio should not serve as the benchmark. Their 401(k) and IRA investments should be part of a sound retirement plan that takes into account their goals, investment objectives, and risk tolerance.
- **If eligible, consider contributing more to their 401(k) accounts.** Maximizing the contributions can reduce Fred's and Frannie's taxable income and potentially lessen the impact of the 3.8% Medicare surtax. In tax year 2013, they both can fund their 401(k) accounts up to \$17,500.
- **If Fred's 401(k) plan allows, consider a 401(k) Roth conversion.** Fred's and Frannie's income disqualifies them from funding Roth IRA accounts. Still, Fred can transfer his pre-tax and company matching contributions into a designated Roth account within the same plan. He'll have to pay federal income taxes on the amount converted, but qualified distributions from the Roth account in the future will be potentially tax-free income. In

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addition, the 10% early distribution penalty doesn't apply to amounts converted. This new law also applies to 403(b) and 457(b) plans that allow Roth contributions.

- **Develop an ongoing plan with a tax and financial advisor.** By working with professionals, Fred and Frannie may learn they haven't incurred any capital gains. Any capital gains incurred in 2013 will be taxed at 15% and not 20% as long as their income remains less than \$450,000. Fred and Frannie learned that the 3.8% Medicare surtax was minimal despite their income exceeding \$250,000. Coordination with their financial team may help them invest with tax efficiency.

#### **Hypothetical Scenario #4: A Well-off Widower**

Dr. Bob Roberts: A 73-year-old private-practice physician and retired U.S. Air Force Reserve lieutenant colonel

Dr. Bob's salary and income: \$570,000 (includes salary, military retirement pay, Social Security, retirement account required minimum distributions and net investment income)

Net worth: \$4.5 million

Financial goals: Avoid risks with his investments

Dr. Bob feels he mostly "dodged a bullet" during the recent recession because when it hit, he had his 401(k), IRA, and taxable brokerage accounts invested in a diversified portfolio with a large amount in cash accounts. He feels somewhat relieved he has recovered some of the value temporarily destroyed by the "Great Recession," but he is concerned that another severe market downturn could jeopardize his wealth.

#### **Dr. Bob should:**

- **Invest cash in retirement accounts.** Dr. Bob has \$560,000 in cash and cash equivalents within his tax-deferred retirement accounts. The new laws mean higher taxes on income, dividends and capital gains for Dr. Bob. Depending on his objectives and risk tolerance, he could allocate the cash in his retirement plans to investments that generate income and dividends. These investments would generally be taxed at higher rates in non-retirement accounts and, in light of the new tax laws, might be better positioned in tax-deferred accounts. Examples include taxable bond funds and dividend-paying stock funds.
- **Consider repositioning to tax-exempt municipal bonds to help minimize taxes.** Making a change to tax-exempt bonds could reduce net investment income and minimize exposure to the 3.8% Medicare surtax. While municipals may not repeat their 2012 performance, municipal securities still present attractive values relative to many fixed-income alternatives.
- **Consider investing in a professional managed account.** Dr. Bob is a busy physician and previously has kept a large amount of assets in cash because of his constraints on

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time, desire and expertise.

- **Regularly consult with his tax advisor and wealth manager.** Coordination with his financial team will help Dr. Bob invest appropriately with tax efficiency. His advisors can develop a plan for managing income, which is taxed at both the highest tax rate of 39.6% and the 3.8% Medicare surtax, as well as a plan for capital gains, which are taxed at 20%. In addition, this team can help Dr. Bob develop a legacy plan for family and charities, in light of the tax law's increase in estate taxes from 35% to 40%.

### **Strategies to Protect Your Financial Security**

- Have adequate **insurance** to protect your income, dependents, and possessions.
- Create a **budget** to control spending so you can save.
- Create an **emergency fund**.
- Save now for your **retirement**.
- Create a **Will or Trust**.
- Create a **financial plan** and update it after significant changes in life.

Very truly yours,

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