



THE  
NORTHWEST  
QUADRANT

"Timing the Market"

Lawrence Solomon, MBA, CFP®

*U.S. v. Kaiser:*  
Taking Action to Shut  
Down Roth IRA Tax Scam

Andrew Vanderhoof, J.D., LL.M.



The Internal Revenue Service has a list of transactions that it deems highly suspect and potentially illegal. This list is known as the "Dirty Dozen," and it includes such things as return preparer fraud, hiding income offshore, and abusive retirement plans.

If someone engages in a transaction that is listed as one of the Dirty Dozen, the IRS will take action to close it down, and for the scam artists and taxpayers involved, it can lead to imprisonment and fines. Taxpayers pulled into these schemes must also repay unpaid taxes plus interest and penalties.

When Roth IRAs were created, it was inevitable that some taxpayers would attempt to exploit their advantageous provisions. In order to minimize Roth IRA scams, the IRS issued Notice 2004-8. In Notice 2004-8 the IRS described how a taxpayer/business owner used a Roth IRA to transfer value between the business he owned and a shell company owned by the Roth IRA. The IRS deemed the strategy a likely illegal tax shelter designed to avoid annual contribution limits. As such, the IRS Notice declared it a listed transaction, subjecting it and other similar actions to additional reporting requirements and increased scrutiny.

The IRS recently took another step in that direction, by filing a complaint in Missouri against an attorney named Kaiser (U.S. v. Kaiser). The complaint resulted in Kaiser being barred from promoting or selling certain Roth IRA strategies that were allegedly designed to circumvent the limit on Roth IRA contributions.

Kaiser allegedly established a self-directed Roth IRA for the benefit of his client. Kaiser was alleged to then have instructed the client to make a small initial cash contribution to the self-directed Roth IRA account. Kaiser then formed a new corporation for his client. The newly-formed corporation generally had no assets, employees, or capital.

Kaiser would then have the client's Roth IRA buy substantially all of the stock of the newly-created shell corporation. Typically, the client's Roth IRA bought 98 percent of the new corporation's stock. An associate of the client would then allegedly purchase the remaining shares, typically two percent of the new corporation's shares.

The client would then shift valuable business assets or income from his or her pre-existing business to the new corporation in one of several ways. Generally, the new shell corporation had no other source of revenue besides those stemming from payments made by the pre-existing business. The dividends from the new corporation were then paid to the Roth IRA because the Roth IRA was 98 percent owner of the new corporation. The clear intent, of course, was to shift otherwise taxable income into the Roth IRA through the corporate dividends.

The IRS will continue to look for transactions that taxpayers use to avoid the limits on contributions to IRAs. Taxpayers should be wary of advisers who encourage them to shift appreciated assets at less than fair market value into IRAs or companies owned by their IRAs to circumvent annual contribution limits. ❖

This quarter, we are pleased to have a guest author, Dr. D. Allen Cohen, writing for my column on investments. Dr. Cohen holds a Ph.D. in Physics and has vast experience in the quantitative modeling of complex problems in the public, private, and academic sectors. We welcome his innovative ideas on investment analysis and portfolio management to this column.

**"Slow-Timing the Market"**  
By Dr. D. Allen Cohen, Ph.D.

In the last couple years we have felt bruised as the market went south. Although, thanks to the balanced-portfolio-allocation philosophy of Navigator Wealth Management (NWM), NWM's clients fared better than most investors, it was frustrating to watch as portfolio values bled and nothing was done to remedy it. The prevailing do-nothing strategy does have merit since, once a market rebounds, it moves quickly and no one wants to miss out. However, I decided to look for a better alternative.

"Bull" and "bear" are familiar market descriptors; they describe statistical market trends. A trend is a sequence of market behaviors that is not purely random. Some statisticians believe that such trends are not real, rather that they are aspects of purely random market behavior. However, bull and bear market trends have been convenient and useful ways to characterize market behavior as follows:

- ◆ Secular, multi-year trends
- ◆ Primary, multi-month trends (a 20 percent change in a quarter indicates a trend transition)
- ◆ Secondary, multi-day trends (rallies and corrections)

In the past 110 years there have been four secular bull and four secular bear trends lasting from 3 to 19 years. From 1973 to 2003 there were five primary bull and six primary bear trends lasting from one month to several years. This explains why the do-nothing strategy has been popular. Secular trends are too long to be useful while primary trend durations are too unpredictable to affect portfolio modifications.

My challenges were to answer the following questions:

- ◆ Do market trends exist whose durations are longer than primary and shorter than secular?
- ◆ Are such trends real?
- ◆ Can trend transitions be identified in sufficient time to realign client portfolios effectively?
- ◆ Do such realignments improve client-investment performances?

My research answered affirmatively to all four.

I developed an algorithmic approach to defining bullish and bearish quasi-secular trends. From 1901 to 2006:

- ◆ There were 23 bullish and 23 bearish quasi-secular trends.
- ◆ Their durations varied from 9 to 59 months.
- ◆ Their median bearish and bullish durations were respectively 18 and 21 months.

The algorithm required, on average, three months to recognize a trend transition.

For example, client analyses using NWM's StrateGem™ model, modified to handle distinct bullish and bearish client allocations, have indicated significant statistical advantages for this strategy. A strategy we call "slow-timing the market." ❖



MANAGING PARTNER

Weston D. Burnett, J.D., LL.M., CFP®

This quarter we will move to ensure that all of our email correspondence to Navigator clients is encrypted when sent. Our broker dealer, and therefore our firm, uses an encryption software service called SmarshEncrypt. The purpose is to safeguard personal information from identify theft, which is becoming an increasing problem.

Due to a recent change in the law, Navigator is now subject to random audits by an auditing firm to ensure compliance with new SEC rules. We regard this as a positive move and have sent letters to all clients who might receive a letter from the auditing firm asking them to check their account balances against our reports.

On the technology side, we are now backing up all our files on the Cloud (i.e., the Web) so that in case of a disaster we could restart with all of our information intact from anywhere. We are also investing in the latest computers for each staff member and a new server. We believe such state-of-the-art technology will make us more efficient and therefore, allow us to better serve our clients. You'll see on the front page article (see page 1) that Navigator has ranked high in the Schwab Benchmarking study in many areas, one being use of technology.

In other firm news, Kathryn Duffy, our new associate, received the good news that she had passed the bar and was recently sworn in by The Virginia Supreme Court Elizabeth Clark was promoted to Manager of Navigator Wealth Operations. Sue Greco started working full-time as our Vice President for Marketing and Sales. Nicci Yang assumed many of Sue's marketing responsibilities, although she will be out on maternity leave from December through January. Mia Citrin is our latest hire as she job shares with Nicci as the First Impression Specialist at the front desk. We have also added two student interns to help out on the Navigator side, T.J. Foley, a graduate student in accounting at George Mason University (GMU), and Nirav Patel, a finance/accounting undergraduate also at GMU.

On the family side, Barb and I have visited all three children this quarter, including both sets of newlyweds in their new apartments or homes. My son David, Mark, Steve Rose (friend of 30 years) and I went hiking with 35-pound packs each in one of the world's seven natural wonders, the Grand Canyon (see picture on page 4). I have some tall tales to tell that are growing with time that I will be happy to share with you upon request. ❖

LESSONS TO MY CHILDREN  
Q&A: Allowances for Kids



I. Mark Cohen and Weston D. Burnett

Co-authors Mark Cohen and Wes Burnett have recently been contacted by reporters and writers from around the country about their book, *Lessons to My Children*, seeking their expert advice on various financial-related topics, ranging from budgeting for teens, to allowances for kids, to credit card debt. In the next few issues of *The Compass Rose*, Mark and Wes will address some practical advice that they are continually asked about, and thought to share with you. To learn more, pick up your copy of LTMC at your local Barnes and Noble, on our website [www.lessonstomychildren.com](http://www.lessonstomychildren.com), or at [www.amazon.com](http://www.amazon.com) (in hard copy or Kindle format).

**Q: At what age should one consider giving a child an allowance? Should a child always get an allowance?**

A: Although it's up to the discretion and financial means of the parent, we suggest structuring an allowance based on the child's ability to associate value to the money he could earn by doing chores or special projects for the family. For example, starting as early as age five, a child will be able to help out by doing small things around the house (i.e., clean his room daily or weekly, walk the dog, collect or take out trash, clean up after the family pet, among other things). When a child develops the desire to buy toys and other things, start early to teach him that he has to save his money for that doll or truck. (Remember that children often lose interest in something they see in a store or commercial if they don't get it right away.) An allowance will also teach the child the value of saving as he watches his money pile up in the piggy bank or bank account.

In terms of whether or not a child should always get an allowance, our opinion is yes from about age 5 to 18. As always, it is up to the discretion and financial means of the parent, but we consider it critical to teach the child from a young age that being part of the family household has shared responsibilities. Nothing comes for free! The child will also learn a solid work ethic that way.

**Q: Should an allowance be based on chores? What about tying it into good grades, good behavior, etc?**

A: We believe an allowance should be based on chores because it teaches a child that along with being part of the family household also come shared responsibilities. Offering "extra pay" for doing special or seasonal projects (like mowing the lawn in the summer, shoveling the driveway, or cleaning out the garage in the Spring), can be beneficial to everyone involved! Parents may even find themselves being asked for more work, especially if their child is trying to save up for something in particular.

We don't encourage giving an allowance for good grades or good behavior. Those are things that are not earned...they should be part of the norm. If you really want to reward good grades or good behavior, why not leave that to the grandparents.

**Q: When should parents consider increasing/decreasing the allowance?**

A: We are firm believers that the allowance should go up over time to cover a wider range of expenses, but should stop at age 18. If the child is headed off to college, she should produce a budget—with obvious help from her parents—on how she plans to pay for college. In turn, the parents should not let the child just go off assuming that the parents are still in charge of her finances and that her only job is to spend it, not earn it, budget it, and track it or anything else. If the child is not headed to college, then she needs to get a job and pay her own way. ❖

# 2010 Year End Tax Planning Tips

## Itemized Deductions & Capital Gains and Losses

Dan Frix, C.P.A.



The end of this year is challenging from a tax planning perspective. Unless Congress and the President act, tax rates and many other beneficial tax provisions for 2010 will expire on January 1st.

We have just witnessed the mid-term elections in which the Republicans have a majority in the House and gained seats in the Senate, but it remains to be seen what will come of the lame-duck session ahead. Whether Congress and the President are able to agree on anything this year in time for you to actually do anything to help your tax position is anyone's guess.

This article presents two strategies which, we believe, are of interest to many of our clients. Which of these strategies you choose, between now and December 31, depends upon whether you believe there will be changes (relief) to the current law or whether the current law will remain unchanged.

**Itemized Deductions:** If you believe that the beneficial tax provisions are going to remain the same in 2011, the appropriate strategy is to increase your itemized deductions. Consider the following: (i) increase your charitable giving in 2010; (ii) pay your January mortgage payment in December, if possible; and (iii) pay your fourth quarter estimated state tax payment in December. By increasing your itemized deductions in 2010, you will lower your 2010 tax bill.

One caution associated with prepaying state or local taxes, or claiming Miscellaneous Itemized deductions: Currently, the exemptions for the Alternative Minimum Tax (AMT) are significantly lower than they were in 2009. If you are likely to be subject to AMT, there will be no tax savings associated with increasing your deductions for taxes or Miscellaneous Itemized deductions.

On the other hand, if you believe that your taxes will be higher in 2011, you may want to defer making any of the foregoing payments until after January 1st. Although you will have a higher tax bill in 2010, these deductions may produce a better return for you by lowering your

income when your taxes are higher.

**Capital Gains and Losses:** Determinations of whether/when to sell or buy investments should be part of your overall investment strategy, and a judgment based on market conditions. Changes to tax rates should not be the "tail wagging the dog" regarding your investments. That said, if you have been planning to buy or sell some investments either at the end of this year or at beginning of next year, you may want to consider the following options.

If you believe that the tax rates for long-term capital gains will remain the same in 2011, you should defer selling any portfolio positions in which you have large capital gains until next year. If you have large capital losses in your portfolio, you should sell them this year so as to take as much loss as possible. You can reduce your ordinary income by \$3,000 for any net-capital losses. If you have net capital losses over this \$3,000 limit, the excess can be carried over to future tax years to reduce income (up to the \$3,000 limit) and/or reduce future capital gains.

One caution: If you are planning to sell your investments at a loss to get the tax break and then reinvest the proceeds to buy the same securities back, you will need to be certain that you do not violate the "Wash Sales" rule. Under this rule, if you buy the same securities within 30 days before or after the date of your loss sale, the loss is not allowed.

If you believe that the tax rates for capital gains will increase in 2011, you may want to sell portfolio positions in which you have large capital gains by the end of this year. Although this will increase your taxable income this year, the lower tax rates in 2010 may offset the effect of not deferring the tax payment.

These points are only the tip of the iceberg of the tax strategies you may wish to consider. If you want to know more about these ideas or want to discuss other strategies, please do not hesitate to give us a call. ❖



Mark and Wes visit the Grand Canyon in October: (L to R) David Burnett, Wes Burnett, Mark Cohen, Steve Rose—a friend of Mark's & Wes' for 30 years, and Muze—a fellow group traveler.

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A compass rose is a figure displaying the orientation of the cardinal directions, north, south, east and west on a map or nautical chart. We found it fitting to name our newsletter after this recognizable symbol of navigation and direction. If you prefer not to receive our quarterly newsletter or if you have any feedback or ideas for topics, please email Susan Greco: [susang@cohenandburnett.com](mailto:susang@cohenandburnett.com).

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# THE COMPASS ROSE

COHEN & BURNETT, P.C. NAVIGATOR WEALTH MANAGEMENT, LLC

ESTATE AND FINANCIAL PLANNING UPDATE

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### FOUNDING PARTNER

I. Mark Cohen, J.D., LL.M., CFP®

**We had a busy Fall at the Cohen household. Kathy did a marvelous job hosting the extended family for Thanksgiving, following which we all drove up to New Jersey for my nephew's wedding, and to meet my other nephew's first child. Yes, my younger brother is already a grandfather! Earlier in October, Wes, his sons David and Edward, and I went on our usual Sea Gull Century 100-mile bike ride.**

**Michael is now a Senior, finishing his final semester towards his undergraduate degree in Government and Arabic language. He is looking to serve in the military in a way that can take advantage of his language skills. Rachel is currently in Granada, Spain, spending her Junior Spring semester abroad. She is working on her degree in Anthropology with a minor in Spanish.**

**Recently I was looking back on the highlights (and lowlights) of the first 10 years of this millennium and saw the Hot-Hand Fallacy chart (see right), which fascinated me. The chart measures the 10-year total return of the CGM Focus fund, the Morningstar "Fund of the Decade." It returned 8.47 percent for the 10 years ending in 2009. What caught my eye, however, was the sad fact that the average investor in that fund lost 22.26 percent! How does that happen? The columns in the chart show fund cash flows. Most of the money went into the fund at its peak in 2007 and then went out at its lowest in 2008. The investors bought high and sold low, the opposite of what works. This example illustrates the risks of chasing fund performance, a common mistake of investors.**

**On behalf of the entire staff at both Cohen & Burnett and Navigator Wealth Management, we wish you seasons greetings and a very happy New Year. ❖**

## NWM Ranks High in Peer Study

This year Navigator Wealth participated in Charles Schwab's 2010 RIA Benchmarking Study, which captures trends and best practices in the Registered Investment Advisor (RIA) industry based on the experiences of individual firms. The final report of the study was compiled by Moss-Adams LLP—an accounting and consulting firm that has conducted benchmarking and research studies sponsored by the top financial service organizations over the years. According to Moss-Adams, Navigator Wealth Management (NWM) stacked up well when compared to "Top Performers" in the wealth management industry. Here's a sampling of the results:

**Firm Growth:** While the economy has been very volatile the last several years, NWM has been fortunate to continue to grow, although slowly. The Moss-Adams report shows that only 9% of Top Performer firms cut staff to improve margins, and 24% actually added staff, NWM being among them.

**Business Development and Marketing:** Referrals continued to be the most productive source of new clients to the Top Performer firms, with 82% of new clients being acquired from other clients and business sources. On par with its peers, NWM attributes 80% of all new clients to referrals.

**Staff Productivity for Client Service:** The study concluded that most Top Performer firms spend 41.6 hours on average per client annually. Client service activities are defined as: financial planning investment research, client meetings, advice development and client communications. NWM exceeded the average with staff spending 77.5 hours annually servicing each client/family.

**Staff Productivity for Operations:** On average, our peers are spending 24.4 hours annually on operational and administrative services for clients (including quarter-end processing, client reporting, setting up client accounts, and rebalancing portfolios). NWM once again beat the averages and clocked in with spending an average of 67.4 hours per client annually.

Overall, NWM fared quite well in comparison to its peers in this milestone study. ❖

### Hot-Hand Fallacy: Chasing Fund Performance Wealth versus Cash Flows 2000–2009



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