The
FINANCIAL UPDATE

DAY & ENNIS, LLC
FEE-ONLY FINANCIAL PLANNING

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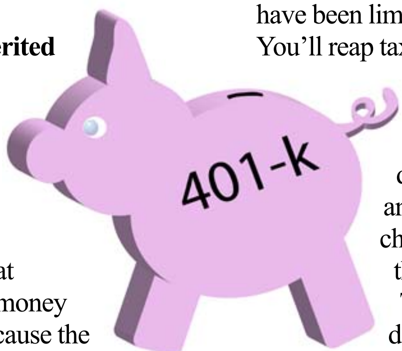
Retirement Rules Change Again, Mostly For The Better

What's in a name? The Pension Protection Act of 2006, signed into law in August 2006 did a lot more than shore up company-sponsored pension plans. Among other things, the legislation stiffened some rules for charitable giving and relaxed others. It permanently establishes several taxpayer-friendly laws that were set to expire after 2010, such as allowing older savers to make catch-up contributions to retirement plans. And it rendered some strategies more attractive than ever. While many of the act's provisions don't kick in for years, others dictate immediate attention. Here are moves to consider.

Roll over an inherited 401(k). Beneficiaries who inherit a 401(k) from someone other than a spouse can transfer the funds to an inherited IRA beginning in 2007. That lets you withdraw the money over your lifetime. Because the withdrawals are taxable, this change is a distinct advantage over old rules that mandated emptying the account in five years or less.



The 401(k) trustee must transfer the funds directly to the bank or investment company holding the IRA—you can't touch the money. There are also rules about how the new account must be titled—"John Smith, Sr. Deceased IRA, For the Benefit of John Smith, Jr." Tranferring the funds to your regular IRA won't work.

Give your IRA distribution to charity. It's always been possible to leave an IRA to charity at death. Now, only during 2006 and 2007, there's another option. During each of those years, if you've reached age 70½, you can distribute up to $100,000 from your IRA directly to a tax-exempt organization (though not to a private foundation or donor-advised fund).

The money must move directly from the IRA custodian to the charity. The withdrawal counts toward your required minimum distribution, so instead of deducting it as a charitable donation, you simply don't include it in income for the year. That's particularly valuable if you don't itemize, or if your charitable-contribution deductions have been limited for other reasons. You'll reap tax savings you couldn't get otherwise.

Hold a garage sale. Effective immediately, donations of used clothing and household goods to charity are deductible only if they are in "good condition." The law's language is decidedly vague, but its intent to restrict deductions for these items is clear. Selling them might be better.

Document all cash gifts. Beginning in 2007, merely saying you contributed to a charity (for example, the donation box at church) won't get you a deduction. You'll need proof such as a bank statement or cancelled check, or a receipt from the charity indicating its name, the amount you gave, and when.

Weigh advice carefully. If you participate in a 401(k) at work, the new law allows your company to give you access to advisors from the plan provider (normally a mutual fund or insurance

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Do You Want One Less Thing To Worry About?

Are you too busy to grab lunch? Are you spending time dealing with your personal finances when you'd rather be playing golf or with your family? If so, we can help.

Our firm is here to liberate you from the managing your financial affairs. You probably have neither the time nor knowledge base to do the job correctly yourself anyway.

If you've ever taken on a "do it yourself" home renovation project, you probably know how much time it can suck out of your life. Even the smallest home improvement can turn into a huge project. Planning your financial future is no different. You probably do not have time to do the statistical simulations that go into making sure your plan is as solid as it can be. You probably don't even have time to learn the math.

As your financial advisor, we can be responsible for handling all the details of your investments, taxes, retirement, insurance coverage and estate plan. Naturally, you'll always know what's happening with your money, but all the pressure—and all the paperwork—will be on our desk, not yours. We'll project your cash flow between the ages of 65 and 90. We'll make sure your assets are titled properly if you have a trust. We'll do all the heavy lifting that you would do if you had the time and training to do yourself.

John R. Day

Inheriting A Spouse's Estate: Understanding

Nothing can erase the emotional havoc you feel when you lose a spouse. But recent changes in IRS laws may help alleviate financial burdens, and understanding the maze of complicated rules for inheritors could help you feel more at ease about your future. Here are several considerations we can review with you.

Maximizing retirement benefits. If you're the beneficiary of your spouse's 401(k), IRA, or other retirement plan, that money is paid directly to you after the death. But keeping it may mean a significant income tax bill. If, instead, you roll over funds to your existing IRA, the money can continue to grow tax-deferred. However, if your spouse had begun taking required minimum distributions (RMDs) from the account—but not during the year he or she died—you'll have to take that RMD before the end of the year.

Another option is to put the money in a new IRA naming your deceased spouse as account owner and you as beneficiary. This may offer extra perks. For instance, if you're not yet 59½, you can withdraw funds without triggering the normal 10% early withdrawal penalty, which doesn't apply to death benefits. Or, if you're older than your spouse and have started taking RMDs from your own IRA, you can leave funds in the inherited IRA until the end of the year in which your spouse would have turned 70½.

> **Regulatory Update**
> **Until recently, taking the RMD the year of a spouse's death meant you surrendered the right to disclaim an IRA. Then came Ruling 2003-36, which says you can take the RMD the year of death and still disclaim some or all of the balance until September 30 of the following year.**

If you're financially comfortable, consider disclaiming (forfeiting ownership of) all or part of the IRA to contingent beneficiaries, who may be younger and could get a disproportionate benefit from long-term compounding. For example, if you disclaimed $100,000 each to your 40-year-old son and 10-year-old granddaughter—and if their only withdrawals were RMDs that continued through their expected lifespans—total pre-tax distributions for the 40-year old could be almost $794,000, and, for the 10-year-old, more than $4.6 million, according to data from T. Rowe Price.

Leveraging trusts' benefits. Spouses benefit from an unlimited marital deduction that lets you inherit any amount from your spouse estate-tax free, provided you're a U.S. citizen. Yet your heirs could be on the hook. Trusts you and your spouse set up could relieve their burden, too.

● If you and your spouse established a credit shelter trust (CST), also called a bypass trust, specified assets passed into the trust at his or her death. You can tap these funds to pay health, education, or other expenses. But because the money went into the trust rather than directly to you, your heirs get the benefit of your spouse's estate tax exclusion, an amount all individuals are entitled to shield from estate taxes.

Suppose you and your spouse jointly own $2 million in assets and your spouse separately has $2 million. While you can inherit all $4 million tax free, your children or other beneficiaries may owe taxes after your death. Their tax bill will be reduced by your estate tax exclusion, the size of which depends on when you die. From 2006 through 2008, you can pass on $2 million tax free, and in 2009, the exclusion rises to $3.5 million. In 2010, there's no estate tax, but in 2011, the exclusion is scheduled to drop to $1 million.

A CST is usually structured so that, when the first spouse dies, an amount matching that year's

Working Long Into Your Retirement Sounds Good In Theory,

It's the fail-safe option for people worried about their retirement nest eggs. A little short on savings? Just work a few years longer. That way, you not only get extra years to save, but you've also shortened the time you'll have to depend on the funds you've salted away. Yet according to a recent study, the reality for many retirees is exactly the opposite. Forced to leave work earlier than planned, they've been left to tap their savings for considerably longer than anticipated.

The survey, by consulting firm McKinsey & Company, found workers approaching retirement increasingly anxious about their prospects. These pre-retirees said they were "very concerned" about a broad range of issues. And their worries had risen sharply in just two years.

• In 2004, 28% said they were very concerned they would have insufficient guaranteed income during retirement; by 2006, that percentage had almost doubled, to 53%.

• In 2004, 15% worried about future cuts to Social Security; in 2006, 44% fretted about impending cuts.

• ï€†In 2004, 35% were very concerned they'd outlive their savings; in 2006, that worry plagued 46%.

The likelihood of working longer. Facing these concerns, almost half of those in the 2006 McKinsey survey said they planned to keep working past age 65. But that's more than triple the 13% of current retirees who have actually done that. On average, current retirees left the work force at age 59, while the average preretiree expects to stay on the job until 67.

Other surveys have found many baby boomers plan to work during retirement out of choice rather than economic necessity. Yet many retirees didn't choose to stop working, according to McKinsey. Some 40% were forced out, mostly because of health reasons (afflicting 47% of

IRS Rules And A Maze Of Choices

maximum estate tax exclusion goes into the trust, thus making full use of that spouse's individual exemption. Then, at your death, the trust assets pass tax free to the trust's beneficiaries, while the taxable amount you pass along is reduced by your own exclusion. Without the trust, your kids would benefit from only one exclusion.

● Many types of marital trusts allow your spouse to specify who will receive his or her property after your death while still offering you extra income during your lifetime. If your spouse has children from a prior marriage, for example, he or she may have established a qualified terminal interest property (QTIP) trust to ensure they receive their share of the estate.

Ask your attorney to review with you the language in all trust documents to make sure you understand the terms and the level of support you may receive.

Slimming down capital gains. If you sell inherited assets, you may owe capital gains tax. The good news is that under current rules, an asset's value is "stepped up" to the market value at a spouse's death, meaning you'll be taxed only on profits exceeding what the asset was worth when you inherited it. For example, if you receive stock worth $5 million, it won't matter that your spouse bought it for $100,000. You'll still be taxed only on proceeds beyond $5 million.

But that tax break ends in 2010, along with the estate tax. If you inherit and sell assets that year, your tax bill could be based on the assets' original purchase price. But all inheritors will be able to increase the tax basis of total inherited assets by a maximum of $1.3 million, and surviving spouses can further inflate the basis by up to $3 million. So if you inherit that $5 million stock your spouse purchased for $100,000, your capital gains will be based on a new tax basis of $4.4 million ($100,000 original basis + $1,300,000 step-up + $3 million spousal provision).

Property given or transferred to your spouse within three years of his or her death, as well as some foreign investments, won't qualify for the 2010 step-up rules.

Knowing the rules of property ownership. If you and your spouse owned property through a joint tenancy with survivorship arrangement—that is, you held property such as real estate, motor vehicles, checking or savings accounts, or government bonds together in equal, undivided shares—you become the owner of that property at your spouse's death.

Joint tenancy is a common strategy for avoiding probate. But owning assets in this way means you can't preserve your spouse's estate tax exclusion.

Only the final survivor in a joint tenancy contract may dispose of the property through a will. So it's important for you to provide in your will for the entire property to be passed along to specified beneficiaries. Otherwise, it will go to your heirs in acccordance with state law.

If you reside in a community property state—Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin—assets acquired during marriage are divided equally after a spouse's death. Each owner may decide who will inherit his or her share of the assets. Establishing a joint tenancy arrangement in a community property state is possible, but complex. You may be allowed only half the step-up basis when you sell, because you technically own only half the assets.

Filing your tax return. You can file a joint return in the year of your spouse's death, unless you remarried during that calendar year, or you could file separately. In addition, if you support a dependent child for whom you can claim a tax exemption, and you haven't remarried, you could file as a "qualifying widow(er)"—equivalent to a joint filer—for two years after your spouse's death.

Be sure to indicate ***"Deceased"*** across the top of a joint return, along with your spouse's name and date of death. As a surviving spouse, you get an additional $1,250 deduction.

These are complex rules, and we know this is a challenging time for you. Always feel welcome to contact us about any concerns you may have.●

But It May Not Always Be Very Realistic

those who quit early) or corporate downsizing (44%).

Other unrealistic expectations. If future retirees can't count on employment earnings, they could reduce spending, and that's what a third of pretirees questioned in the McKinsey survey said they planned to do. But just 10% of current retirees have been able to cut outlays significantly. And while 31% of those approaching retirement expect to improve their financial situation by moving to a smaller home or a cheaper area, only 7% of retirees have downsized. The one area in which expectations matched reality is in the use of home equity; 13% of future retirees expect to take a reverse mortgage or home equity loan, and 13% of current retirees have done just that. However, with savings dwindling, another 25% of retirees are thinking about borrowing against their homes.

The upshot of all this may be a simple if inconvenient truth: the best way to ensure a comfortable retirement remains prudent saving and investing. If you're concerned about whether your retirement plan is on track, call our office and we'll be happy to review your situation with you.●

Why To Consider Selling Assets Before 2011

If you're wavering about whether to sell your grandmother's home or an investment that may still be gaining value, now you can take your time making the decision. Congress recently extended the 15% maximum tax rate on long-term capital gains, a move that is expected to bring a total of $149.7 billion in tax savings to investors. The provision had been set to expire at the end of 2008, but now will remain in effect through 2010.

A long-term capital gain is the profit you earn selling an asset you own for at least one year. If, for instance, you purchased stock for $1,000 and sold it years later for $1,000,000, taxes are calculated based on a $999,000 gain. Until 2003, you'd have owed Uncle Sam as much as 20%—$199,800 in this example. At a 15% rate, you pocket an extra $49,950, owing taxes of only $149,850.

Homeowners who sell enjoy an additional tax break. You can exclude from capital gains up to $250,000 ($500,000 for married couples) of profit on the sale of your home. To qualify, your home must have been your principal residence for at least two of the five years prior to the sale.

What about assets I own for less than a year? When you sell these "short-term" assets, profits are taxed as ordinary income, at a rate of up to 35%. The same rule applies to collectibles such as coins or art regardless of how long you own them.

An extension of lower tax rates on long-term capital gains could save taxpayers a total of $149.7 billion

What if I lose money on a sale? Losses on the sale of long-term assets can offset capital gains, plus you can deduct up to $3,000 in losses from your income each year. Excess losses can be carried forward to future tax returns.

Things may get trickier if you sell inherited assets. Currently, the value of assets you inherit is stepped up to the market value at the death of their owner. When you sell, you're taxed only on profits exceeding what the assets were worth when you received them. For example, if your Uncle leaves you $5 million in stock for which he originally paid $100,000, you're taxed only on sale proceeds exceeding $5 million.

But that tax break ends in 2010, along with the estate tax. If you inherit and sell assets that year, your tax bill will take into account the assets' purchase price. But inheritors will be able to increase the tax basis of total inherited assets by a maximum of $1.3 million. (Surviving spouses can further inflate the basis by up to $3 million.) So if you inherit that $5 million stock your uncle purchased for $100,000, your capital gains will be based on a new tax basis of $1.4 million ($100,000 original basis + $1,300,000 step-up).

If you've hesitated to sell certain assets whose value may still be rising, remember to factor in the new rules on capital gains, which could affect your ultimate tax bill. ●

Changing Retirement Rules

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company). Make sure any advice is consistent with the objectives of your financial plan.

Consider an in-service distribution. The new law lets participants in company-paid pensions who are at least age 62 receive benefits from the plan even if they're still working. Previously, you had to be 65.

Diversify employer stock. The legislation makes it easier for workers at public companies whose retirement plans offer the company's stock to sell their shares. That should help you keep your portfolio from becoming dangerously over-concentrated.

Donate a conservation easement. The income-tax deduction for placing a permanent conservation easement on property and donating it to a qualifying organization was formerly limited to 30% of income for the year, with the remainder deductible over the following five years subject to the same restriction. Now, just for 2006 and 2007, you can deduct up to 50% of income (100% for certain farmers and ranchers), and you get 15 years to use the deduction.

Get ready for the Roth 401(k). The law permanently establishes the Roth 401(k), a new type of retirement account that came into existence in 2006 but had been authorized only through 2010. Now, more employers are expected to offer it. You may contribute after-tax dollars to a Roth 401(k) regardless of your income, and investment earnings may be withdrawn tax-free after five years if you're at least age 59½.

In 2006, workers may put a maximum of $15,000—or $20,000, if you're at least 50 by year end and your company allows catch-up contributions—in all 401(k)s. Whether your money should go to a traditional 401(k) or a Roth hinges largely on your current and future tax brackets. In general, if you expect to be in the same or a lower bracket when you withdraw money from the account during retirement, a traditional 401(k) is preferable because it delays the tax. If you may be in a higher bracket when you retire, the Roth may be better, though when you expect to quit working also factors into the analysis. ●

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