The
FINANCIAL UPDATE

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FEE-ONLY FINANCIAL PLANNING

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Pre-Retirees, Retirees Switch To Roth IRA

Converting a regular IRA to a Roth IRA brings a host of benefits. Unlike a traditional IRA, which requires you to begin withdrawing money from the account after you turn 70½, a Roth has no mandatory distributions. If you don't need the money, you can leave it to compound for the rest of your days. Even better, if you're at least 59½, any money you do take out—assuming it has been in the account five years or more—is tax-free. In contrast, withdrawals from a regular IRA are taxed as regular income.

If you are in your 60s and have a low income and big tax deductions, a Roth conversion can be almost painless.

So why doesn't everyone convert to a Roth? One reason is the current $100,000 income limit for conversions. The other problem is taxes; to convert to a Roth, you must first take money out of your traditional IRA, and that means paying income tax. However, if you are in your 60s and have a low income and big tax deductions, a Roth conversion can be almost painless. You can make the switch without creating a huge tax bill, avoid paying taxes on much of your retirement income, and provide tax-free income for your heirs as well.

To see how this would work, consider Frank and Sylvia, a fairly typical couple on the verge of retirement. He is 61 and a hospital administrator; she's a 55-year-old homemaker. They have managed to sock away $600,000 in Frank's pension plan and $400,000 in regular IRAs. They have another $600,000 invested in tax-free municipal bonds.

Frank wants to retire this year, and it turns out that he and Sylvia are in an ideal situation to convert some of their IRA assets to a Roth. Not only are they far under the $100,000 income threshold, but also, like many people their age, they can control how much income they receive in a particular year. For instance, Frank can choose to delay receiving Social Security until age 65, and also can defer payments from his pension. Keeping your income down when you're converting to a Roth IRA means that the money you pull out of the regular IRA will be taxed at a low rate or may not be taxed at all.

Apart from interest and dividends flowing from a savings account and investments in a few mutual funds, almost all the income Frank and Sylvia will receive after he leaves his job will be from their tax-free municipal bonds. They will have less than $10,000 of taxable income, and once their exemptions are figured in, that figure will drop to almost zero.

Meanwhile, the mortgage interest and property taxes Frank and Sylvia pay on their primary residence and vacation home provide a $40,000 annual deduction for the next several years. The perfect use for that deduction, which

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More About Market Trend Allocation™

We recently commented on Market Trend Allocation™—a strategy we have developed to select portfolio investments based on their risk relative to changing market conditions. It offers our clients a means of risk management that is more proactive than a "buy, hold, and rebalance" strategy.

By using selected indicators, we identify the beginning or end of major market cycles by asset class. We look for trends that last several months or years, not short-term daily or weekly trends. When it benefits clients, we use this knowledge to adjust the percentage weightings in our asset allocation.

We will also be considering these factors:

1. Growth rates in the United States are likely to be lower than those in emerging markets such as China, India, and Brazil.
2. Because of the amount of money that has been dumped into the system in the United States, there is a strong possibility of increased inflation and rising interest rates.
3. Commodity prices may increase significantly, especially if inflation increases and the value of the dollar decreases.

We believe Market Trend Allocation™ will be particularly helpful in portfolio rebalancing as our markets begin to recover.

John R Day Bill Ennis

The Tax Rules Of Buying Or Selling A Home

Though the mortgage-interest deduction may be the most obvious example of the government's largesse to home-owners, other significant breaks apply when you buy or sell a home. People buy or sell a home for lifestyle reasons and not for tax reasons. But knowing the tax rules can save you a bundle on a house sale by keeping your tax bills to a minimum. Consider these strategies.

Don't sell too soon. With the way that home prices have appreciated over time (despite the recent decline), selling your house could net you a major profit with no tax bill—unless you make your move too soon. If you've lived in a home for at least two of the past five years, you can exclude up to $250,000 of your gain from capital gains taxes; if you are married, you and your spouse can avoid taxes on a profit of up to $500,000. If you sell after just a year, however, you'll be taxed on your profit at the 15% rate for capital gains—and if you sell a place you've lived in less than 12 months, your gain is considered short-term, and taxed at your ordinary income rate of up to 35%.

Plead hardship. So-called hardship sales—necessitated by medical problems, divorce, job loss, or multiple births—could win you a tax break even if you sell before living in your home for two years. If you qualify, you'll get a reduced home-sale exclusion based on your amount of time in the house, expressed as a fraction of the ordinary two-year minimum. If you sold after 18 months, for example—three-quarters of the minimum—you could exclude a profit of up to three-quarters of the usual $250,000 or $500,000 exclusion.

Minimize your gains. If you have to pay tax on your profit, look for ways to increase your home's tax basis—for example, by including the closing costs you paid when you bought the house. A higher basis means a smaller gain. However, if you depreciated a portion of the house because you used it for business purposes—such as for a home office—you'll generally owe capital gains tax on some or all of the depreciated amount.

Latch onto a new tax credit. If you're a first-time homebuyer—someone who has not owned a principal residence for the prior three years—you can claim a credit of up to $8,000 for a home purchased after 2008 and before December 1, 2009. But the credit is phased out for high-income taxpayers.

Get the points. When you take a mortgage for a new home, you may pay "points" in exchange for a lower interest rate. Because the IRS considers points to be prepaid mortgage interest, you may be able to deduct them from your income for the year of the purchase. For instance, two points paid on a $500,000 mortgage—that is, 2% of the half-million—would give you a $10,000 deduction. However, if you finance the points along with the mortgage balance, you must deduct them over the life of the loan. Spread over the term of a 15-year mortgage, for example, that same $10,000 would mean a deduction of only $667 a year. ●

Federal Estate Tax Exemption... Going Up!

At long last, we're approaching the final step of a long climb for the federal estate tax exemption—the value of assets in an individual's estate that is shielded from potential estate tax liability. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the exemption amount (also known as the *Applicable Exclusion Amount*) gradually increased to $2 million for 2008, and has finally jumped to $3.5 million for 2009.

As the exemption has risen, the top tax rate for estates has declined to 45% in 2009, and under EGTRRA, the federal estate tax is scheduled to be repealed completely for 2010, only to return at pre-EGTRRA levels in 2011. While that still might happen, there's a growing consensus for congressional compromise that would keep the estate tax but with a high exemption level—perhaps 2009's $3.5 million.

With these changes afoot, it makes sense to take a fresh look at immediate and long-range estate plans. At a minimum, you should consider the implications of the higher estate tax exemption amount for 2009.

Prior to EGTRRA, the federal estate tax exemption for 2001 was only $675,000. But EGTRRA raised the exemption to $1 million for 2002 and started scaling back the highest tax rate from 55%.

If the estate tax makes its scheduled exit in 2010, which many believe is unlikely, another change will complicate tax planning. Under current law, people who inherit assets are allowed to "step up" the assets' cost basis to their market value at the owner's death. That step-up is supposed to go away in 2010, with heirs instead inheriting the original cost basis. That could increase capital gains tax liability when the assets are sold, and could force heirs to have to go through years of old documents to determine their basis. But there will be two key exceptions—a one-time $1.3 million step-up in basis, and an additional $3 million

Working Longer To Fix The Retirement Mess

Are you willing to postpone retirement by two to four years? If you want to enjoy a secure, prosperous retirement, delaying it may be the best way to get there, according to a new book published by the Brookings Institution Press. *Working Longer: The Solution to the Retirement Income Challenge* offers a sobering yet hopeful message to Americans approaching retirement age at a time of soaring health care costs, declining pensions, severely weakened retirement accounts, and shaky prospects for Social Security.

Authors Alicia H. Munnell, professor of management sciences at Boston College, and Steven A. Sass, associate director of the Center for Retirement Research at Boston College, argue that raising the average retirement age from 63 to 66 would solve many of the financial problems retirees are facing. “The key is to avoid drawing on your Social Security benefits or 401(k) plan until age 67,” says Sass. Allowing your retirement assets to grow just a few years longer can significantly boost your assets, and delaying retirement means a shorter period during which you’ll have to depend on retirement savings.

The nice thing about this strategy is that it won’t necessarily mean enjoying fewer years of post-work life. Because life expectancy has soared while the average age of retirement has fallen, merely moving back the start could still afford you decades of doing whatever you have planned. Consider these numbers:

- The average life expectancy for a 55-year-old man in 1965 was 20 years; by 2005, it had risen to 25 years.
- For women at 55, life expectancy rose from 25 years in 1965 to 29 years in 2005.
- About 19% of men and 33% of women who survive to age 65 today will live to age 90 or older.

Meanwhile, the average retirement age for Americans fell from 65 in the mid-1960s to 63 in the 1980s, where it remains today. A major reason is that workers may start receiving Social Security benefits at age 62, even though beginning then, rather than waiting until full retirement age, reduces the amount of the monthly payments you’ll receive. And while Social Security’s official retirement age is gradually rising from 66 to 67, the government has opted to leave the earliest eligibility age (EEA) at 62. Sass and Munnell believe the government should push back the EEA to age 64 to encourage people to remain in the work force longer.

The declining U.S. savings rate is another strong argument for staying on the job a few additional years, suggests Sass. “For baby boomers, it’s getting a little late to save.” They don’t have that much money in their 401(k) plans. Working longer is probably the best option.”

Sass notes that the amount of your Social Security benefit is calculated using the 35 highest-paid years of your working life. “By delaying retirement, very often you’ll replace a zero- or low-earnings year and actually increase your benefit level,” he says. Moreover, each year you wait before starting Social Security payments will boost the amount. Work four years longer, Sass estimates, and you’ll increase your monthly check by a third.

Consider a man who made an average of $150,000 a year during his highest-paid 35 years at work. If, rather than retiring at age 62, he keeps going four more years at that same average salary, his benefits will go up more than 30% compared with what he would have received at 62, not taking inflation into account, Sass says.

If the same man had earned an average of $150,000 but had worked only 31 years, his 35-year Social Security average would be lower. (The exact figure is calculated based on the Social Security wage base limit, which changes annually and stands at $106,800 in 2009.) Retiring at age 66 instead of 62 would add four more years to the average (at the wage base limit), thus increasing his benefits somewhat more than the automatic 30%.

For a person earning an average salary of $40,000 a year, adding four more years to a 31-year average would make the increase in benefits rise from 30% to 45%, according to Sass. For higher earners to receive a similar extra boost, the wage base limit would have to be increased significantly above the $106,800 level.

The recent meltdown in the stock market just adds one more reason to think about delaying retirement by a few years. Most nest eggs have suffered, and to begin withdrawals from a beaten-down retirement account may sharply reduce the size of annual distributions that can be taken without depleting the account during a long retirement. We can revisit your retirement plan with you and help you choose a retirement age that will support your goal of a long and comfortable life after work. ●

step-up for assets inherited from a spouse.

While much about the future of the estate tax remains up in the air, you may need to review your will and trust documents because of the 2009 change to a $3.5 million exemption. Wealthy couples may also want to keep up to $3.5 million in assets in each spouse’s name to make the most of the estate tax exclusion. A credit shelter trust, for example, may use the maximum exemption to establish how much goes into the trust when the first spouse dies. But using the new, higher amount could shortchange the surviving spouse unless special provisions are made.

One strategy the new exemption level doesn’t affect is your ability to reduce your taxable estate through lifetime gifts. The annual gift tax exclusion increased in 2009, to $13,000 per recipient from $12,000 per recipient in 2008.

We can work with you and your estate planning attorney to determine whether your estate plan should be revised to factor these and other possible changes in estate laws. ●

Estate Tax Exemption In Flux

Tax Year	Estate Tax Exemption ($)	Maximum Tax Rate (%)
2009	3.5 Million	45
2010	Unlimited	0
2011	1 Million	55

Financial Plans Are Meant To Be Revised

One great benefit of a financial plan is that it gives you a feeling of certainty. Designed to take into account wide-ranging scenarios, it seemingly should be able to shrug off an uptick in inflation, a bear-market stretch for stocks, or a spike in interest rates. Yet there are some circumstances —such as the recent once-in-several-decades plunge of the economy and financial markets—that even the most carefully constructed plan can't fully anticipate. Such events, as well as possible changes in your own situation, mean that every financial plan, sooner or later, will have to be revised. Preparing a financial plan is a process, not a one-time event, and making smart, timely alterations is crucial.

Consider how that process works. A financial advisor takes stock of an investor's overall financial situation and asks questions about goals, comfort level with investment risks, and the timetable for using investment proceeds. Then, the advisor establishes a comprehensive plan designed to help achieve those objectives.

That requires several assumptions about how markets and the economy will behave.

For example, an advisor might base a plan on a projected inflation rate of 3%, an 8% average annual return for stocks, and 4% yearly gains for bonds. Though some or all of those assumptions might miss the mark, the idea is that, taken together, they should be close enough to be useful.

Yet even small inaccuracies, left uncorrected for 20 or 30 years, will leave a plan seriously out of whack.

Think of a ship setting out from New York for, say, Lisbon. The captain charts a course that should take the ship across the Atlantic to Portugal. But what if he makes a small miscalculation? Even if he's off only 1%, that could be a problem, and unexpected changes in winds and currents along the way are likely to make things worse. If he sticks to his original bearings, he could end up in Africa—or Ireland.

But that won't happen, because every good sailor understands the need for minor but constant course corrections. And a financial plan requires similar adjustments. Look at the predictions of economists, market forecasters, or the government, and you'll see that no estimate extending more than a year or two into the future will be even close. So a financial plan written to predict the feasibility of a retirement 30 years away won't—and can't—be accurate. But it can establish a starting point. Reaching your goals requires frequent adjustments to compensate for the winds and currents you meet along the way.

Once you understand that basic certainty, you can prepare by discussing how, and under what circumstances, your plan will need to be altered. We would be happy to review your plan with you to make sure it continues to move you toward your long-term goals. ●

Switch To Roth IRA

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would otherwise go to waste, is to offset $40,000 a year in income from IRA withdrawals which can then go into a Roth IRA. If they do this for four years, until Frank reaches 65 and must start receiving income from Social Security and his pension, they'll salt away $160,000 in the Roth IRA.

To give them the $85,000 a year they need to live on in the meantime, Frank and Sylvia can tap the principal from their $600,000 muni-bond account. Spending investment principal is psychologically difficult for some retirees, but in many situations it makes good financial sense.

In this case, selling some of their munis now helps Frank and Sylvia avoid taxes later. Once he reaches 65 and starts receiving Social Security and his pension, they are likely to be in the 28% tax bracket or higher. Money they take out from a regular IRA would be taxed at that rate, and after age 70½ annual withdrawals would be mandatory. That won't be a problem with the assets they've moved into the Roth IRA; they won't have to make withdrawals, but funds they do pull out are tax-free.

In addition, if Frank names his children beneficiaries of the Roth IRA, they will inherit a stream of tax-free income. According to Roth IRA rules, they can stretch out tax-free payments for the rest of their lives.

Future tax breaks: The $100,000 dollar cap for Roth IRA conversions is scheduled to be removed beginning in 2010. What's more, for a conversion occurring in 2010, you can elect to spread out the resulting tax liability over the following two years. ●

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