The
FINANCIAL UPDATE

Fourth Quarter 2009 NAPFA - Registered Financial Advisor (478) 474-7480

Do Roth IRA Conversion Rule Changes Help You?

Why would you volunteer to pay income tax next year by converting a traditional IRA to a Roth IRA? If you leave things alone, you won't owe any current tax on the assets in your account, regardless of their investment performance. But the promise of a future tax payoff—combined with the prevailing economic conditions—may warrant this unusual approach. And thanks to a recent tax law change, a conversion to a Roth in 2010 will be a possibility for all investors, regardless of income.

With a traditional IRA, contributions may be tax deductible, but the amount you deduct and subsequent earnings will be fully taxed as income when withdrawn during retirement. (The same rules apply to IRAs holding assets rolled over from traditional 401(k)s or other employer-sponsored plans.) And you generally begin taking those taxable distributions during the year in which you turn age 70½.

In contrast, contributions to a Roth IRA are never deductible, but qualified distributions from a Roth that has been established for at least five years are completely tax free. And because the government won't benefit when you take distributions, it doesn't require you to take them.

Until now, the catch has been that high-income individuals can't contribute to a Roth IRA, and converting a traditional IRA to a Roth hasn't been allowed if your adjusted gross income exceeds $100,000. The latter rule changes in 2010, when the income cap for conversions is eliminated. And though a conversion to a Roth requires you to pay income tax on the amount you convert, if you make the conversion in 2010, you're allowed to spread out your tax payment over 2011 and 2012.

Choosing between saving for retirement with a traditional IRA or a Roth is in part a question of whether it's better to pay the IRS sooner or later. Being taxed on current contributions to a Roth IRA or for a conversion from a traditional IRA takes money out of your pocket now, but you may do better later, either enjoying tax-free distributions or passing along the account to your heirs, whose withdrawals also won't be taxed. But the law permitting anyone to convert to a Roth, coupled with the bear market's depressed asset values, adds interesting twists to this debate. Consider these three reasons it may pay to convert.

1. You'll avoid a higher tax bill later if rates rise. With individual tax rates at near-record

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The Fiduciary Difference

Congress is debating legislation to re-regulate the financial industry. The Financial Industry Regulatory Authority (FINRA), which regulates stockbrokers, is pushing to oversee Registered Investment Advisors as well. According to testimony from FINRA representatives, the goal is to dilute the meaning of "fiduciary" so stockbrokers could use the term as well.

Since Day & Ennis is a Registered Investment Advisor, we would like to review the present industry standards. We are fiduciaries, and as such are required by federal law to act solely in the best interest of clients, even if it conflicts with the advisor's financial interest. Registered Investment Advisors must adopt a code of ethics and fully disclose how they are compensated.

Unfortunately, only a small proportion of "financial advisors" are Registered Investment Advisors under federal law. Most are considered "broker/dealers" by the Securities & Exchange Commission—the SEC. In fact, broker/dealer affiliates are required by federal law to act in the best interest of their employer, which may not be in the best interest of their clients.

At Day & Ennis, we will remain fiduciaries by the present definition. We sell no products and do not accept any commissions. Our compensation is fee-only and fully disclosed to our clients.

John R Day   Bill Ennis

Rule Change Helps Non-Spouse Rollovers

Most 401(k)s and other employer-sponsored retirement plans are bequeathed to spouses, and with good reason. Until a recent change in rules, only a spouse could inherit a retirement plan other than an IRA and avoid immediate taxes. Now, although the process must be handled carefully, any beneficiary should be able to receive a retirement plan and enjoy the same tax-postponing benefits that a husband or wife always could.

Under the old rules, if your spouse got the money, it could be rolled over into his or her own IRA and lifetime withdrawals would be permitted. Though each year's required distribution would add to your spouse's taxable income, the rest of the account would continue to compound, and there might be a sizable balance left at your spouse's death.

But what about your daughter? Most employer plans require an account to be emptied within five years of an employee's death. She would have had to take the money and, under the old rules of not being allowed to move it into an IRA, would have been stuck paying income tax immediately, which likely would have diminished her inheritance by a third or more.

The new rules are much kinder to non-spouse beneficiaries. Now, any beneficiary that you name may roll over the inherited plan to an IRA. But the law is prickly about the process. To make a successful rollover, your heir must do the following:

- Open an inherited IRA to take the money. A spouse who inherits a 401(k) can merge the account with her own IRA, but others must set up a new account specifically created to receive funds transferred from the deceased's retirement plan.

- Be sure to title the new account correctly. For instance, "Dad IRA (Deceased) FBO Daughter."
- Make sure the money goes directly from the company plan to the heir's new IRA. If your beneficiary touches the money, he or she will be immediately taxed.

If you've ever changed jobs, you may already have transferred retirement funds from your former employer to an IRA. Until the rules changed, that was the only way to ensure favorable tax treatment for a non-spousal heir. And even now, a rollover to an IRA of your own is often advisable. IRAs tend to offer a wider range of investment options than you get in a typical 401(k), and it's easier to monitor investments in a single account. Moreover, you may feel a lot more comfortable having the funds deposited in your own IRA rather than an account being administered by a former employer.

There is at least one advantage to keeping money in a 401(k), however. If you retire, you may begin taking distributions from an employer plan at age 55 without incurring the 10% early withdrawal penalty you would owe for withdrawing assets from an IRA before age 59½. Under the new rules, you can have the penalty-free early access of a 401(k) while also accommodating non-spousal heirs. ●

New COBRA Benefits For Those Laid Off

If you're one of the millions of Americans who have lost jobs during this recession, finding a way to keep employer-provided health benefits is probably a top priority. The American Recovery and Reinvestment Act of 2009 could make that much easier, reducing your cost in most cases by almost two-thirds.

Under a 1986 federal law commonly known as COBRA (Consolidated Omnibus Budget Reconciliation Act), an employer with 20 or more employees must offer full-time employees the option to continue group health insurance coverage following a "qualifying event." (Other employers may volunteer to provide COBRA coverage.) If that event is a termination or reduction in hours, you're eligible for 18 months of extended coverage, which could be extended to 29 months if you've suffered a disability or 36 months if you're a spouse or dependent facing loss of health coverage because of an employee's death, divorce, or legal separation. Although a company has to let you keep your insurance under those circumstances, it doesn't have to pay for it. You'll generally be on the hook for the full cost of coverage plus a 2% administrative fee.

Under the Recovery Act, your former employer may have to share that burden. Anyone who is involuntarily terminated from employment during a 16-month period—from September 1, 2008 through December 31, 2009—can elect to pay only 35% of the cost of continued health insurance coverage for up to nine months. The employer is responsible for the other 65%, though it can offset that obligation through a payroll tax credit, reduced withholding, or both.

There are income limits,

The Ins And Outs Of Lifetime Gifting

It's a simple truth of estate planning. Giving money to your heirs while you're alive is almost always a better deal, in terms of taxes, than having your wealth distributed after you're gone. Yet, according to a recent survey by Charles Schwab, though seven in 10 affluent individuals consider estate taxes a major concern, fewer than a third say they have taken advantage of lifetime giving strategies that could cut their potential estate tax liability.

The following example shows why it's better to make gifts sooner than later. Suppose you earmark four quarters for your children. If you die and are in the highest estate tax bracket, almost 50% of your gift will go to the government. So, the kids get just two quarters. Now suppose, instead, you gave them two quarters now. You might owe gift tax, again at about a 50% rate. That costs you one quarter, not two, and your children get to keep the extra 25 cents.

Under the first scenario, your kids get 50 cents, total. Under the second, they get 50 cents in gifts plus about half of the last quarter after paying estate taxes when you die. They end up with roughly 25% more than they'd have gotten without the gifts during your lifetime.

In reality, your children would probably make out even better. That's because the IRS lets you give as much as $13,000 annually (a couple can give $26,000) to any number of recipients without incurring any gift tax. A couple with three children, for example, could transfer $78,000 a year to the kids throughout Mom's and Dad's lifetimes without ever owing a penny in gift tax. Moreover, you can make unlimited tax-free gifts to your spouse as long as the spouse is a U.S. citizen.

Additionally, you can provide "support" to your children or dependents without it being considered a gift. The same is true when you make payments on behalf of your children or others for tuition to educational institutions and medical providers.

All of this adds up to a considerable sum you can move out of your estate without paying taxes. And there's more. You also get a lifetime gift-tax exemption of $1 million. Any time you exceed the $13,000 annual limit, the excess is counted against your exemption. So, for example, if you give your daughter $25,000 this year, $13,000 will be forever exempt from gift taxes, and the other $12,000 must be reported to the IRS and subtracted from your $1 million exemption. Only when the exemption is used up do you owe any gift tax.

Some wealth-transfer strategies can help you stretch your exemption even further, by discounting the value of your gifts so that a gift actually worth $15,000, might count as just $13,000 for tax purposes, and wouldn't exceed the annual exemption amount. Valuation discounts can apply to gifts of interests in real estate, businesses, or securities, among other assets. In some cases, the gift is discounted because of a lack of liquidity or control; in others, it represents a remainder of interest paid after a period of time. These strategies may involve a qualified personal residence trust, grantor retained annuity trust or unitrust, or family limited partnership.

Keep in mind that some gift-giving strategies may involve paperwork. If you go above the $13,000 annual limit, for example, you must file a gift tax return. Couples taking advantage of the "splitting" provisions that allow them to give $26,000 a year also need to file the return, even though their gifts don't reduce their lifetime gift exemptions.

If the estate tax is repealed on schedule in 2010 (and no one can know for sure how that will turn out) you could live to regret having paid gift taxes. But unless Congress acts to extend the repeal, which is unlikely, the estate tax comes back to life in 2011, and distributing all or part of your wealth before you die and not afterward could really help your heirs keep a larger share.●

however. If, during the year you claim the new COBRA benefits, you still earn $125,000 in modified adjusted gross income (MAGI) for single filers or $250,000 if filing jointly, you'll get only a partial benefit, and you'll get no help if your MAGI exceeds $145,000 for single filers or $290,000 for joint filers. If you received the reduced premium and then exceed the income ceilings, you'll have to pay back the money when you file your taxes. The IRS is also expected to provide further guidance on the definition of "involuntary termination." It's likely to cover layoffs or job eliminations but not firings with cause.

Finally, the new COBRA relief can be combined with another tax break if you lose your job. This year's recovery law allows you to avoid income tax on up to $2,400 of unemployment benefits in 2009. For more information about the COBRA premium reduction, go to http://www.dol.gov/ebsa/faqs/faq-cobra-premiumreductionEE.html or call 866-444-3272. ●

Marital Trusts: The Devil Is In The Details

The marital trust is a powerful estate planning tool that can maximize estate tax benefits and allow you to control what happens after your death. But mistakes in execution, particularly involving funding, could undercut its usefulness.

Though the federal estate law has been in flux during recent years, there has been one constant—that one spouse can receive an unlimited amount from the other without gift or estate tax liability. (Note: The marital deduction is generally disallowed for non-citizen spouses.) The basic idea of a marital trust is to fund it with those inherited spousal assets. All trust income goes to the surviving spouse, who may also be able to use some of the assets—living in the family home, for example, or tapping trust principal to pay for long-term care.

One common alternative to the marital trust is known as a credit shelter trust (or bypass trust). By any of these names, a credit shelter trust is designed to make sure each spouse's personal exemption for federal estate tax—$3.5 million in 2009—is fully utilized in reducing the overall taxes for a couple's estate. Suppose you and your spouse together have assets worth $7 million. You could set up the trust so that when either of you dies, that person's exemption is used to fund the trust with $3.5 million. That tax-free transfer reduces the value of the estate to $3.5 million, and the trust income can be paid to the surviving spouse. Then, at the second spouse's death, the trust assets are directed to your children or other heirs without estate tax liability. The remaining $3.5 million (under current law) outside the trust can also be passed along to beneficiaries without federal estate taxes using the second spouse's exemption.

For this scenario to play out exactly that way, however, you would both have to die when the exemption is $3.5 million, as estate tax laws are in flux. The federal estate tax is scheduled to be repealed in 2010, only to be revived in 2011 under revised rules, including an exemption of just $1 million. It's probable there will be legislation to prevent the repeal of the estate tax in 2010, as the government is in need of revenue fund its operating deficit. Until a permanent solution for the estate tax is created, estate plans must be crafted carefully and revisited periodically to avoid unintended consequences.

Funding a credit shelter trust can also be tricky. Normally, it's funded through a pecuniary or fractional bequest. A pecuniary bequest sends a fixed dollar amount to the trust, while a fractional bequest delivers a percentage share of the assets. Problems may occur if the language of the will leads to underfunding and unexpected estate tax for the heirs. Since there can also be errors in how individually or jointly owned property is used, it is very important to consider with which assets to fund the trust.

With all of the potential snafus, it's essential that everything is handled properly. We can work with you and your attorney to create an estate plan that meets your objectives.●

Roth IRA Conversion

(Continued from page 1)

lows and tax revenue falling far short of federal budget commitments, tax rates are likely to go up in the near future. It may be better to take your lumps under current tax law—even if all or part of the conversion is taxed at the top rate of 35%—than to risk losing much more of your investment to the IRS later.

2. Converting to a Roth IRA gives you maximum flexibility on distributions. There's not much give in the rules on withdrawals from traditional IRAs and 401(k)s. Beginning the year you reach 70½, you'll face minimum annual distributions designed to use up the account during your expected life span—and you'll pay a 50% penalty on any shortfall from the required amount. With a Roth, you can take as large or small a distribution as you choose each year, and you have the option of leaving the account intact to provide tax-free income to your heirs.

3. A partial conversion to a Roth lets you customize your tax liability and benefits. A Roth IRA conversion needn't be an all-or-nothing proposition. You can convert as much or as little as you want each year (although the option of stretching out tax payments applies only to conversions in 2010). Making a partial conversion lets you limit current payments to the IRS while also providing some tax-free income during retirement.

We can help you decide whether a conversion makes sense in terms of your unique situation and overall financial goals.●

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