



Roth IRA Conversion Rule Changes Offer Opportunity

Why would you volunteer to pay income tax this 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 2006 tax law change, a conversion to a Roth in 2010 is 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may be tax deductible, but the amount you deduct and subsequent earnings will be fully taxed as income when withdrawn during retirement.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 must begin taking those taxable distributions during the year after 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 changed in 2010, when the income cap for conversions was 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 on 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 four reasons it may pay to convert.

1. You'll pay less to convert an IRA whose value has plummeted. Rare is the investor who hasn't seen retirement account values fall by at least 25% during the bear market. As painful as that has been, however, it can be an advantage if you choose to convert to a Roth IRA in 2010. You'll be taxed on the value of the account at the time of the conversion, regardless of what it may have been worth a few years earlier. Suppose the assets in your IRA were worth \$500,000 two years

(Continued on page 4)

What's The No. 3 Uncertainty After Death And Taxes?

If death and taxes are life's two certainties, then death taxes being a mess is number three. Recent proposals in Congress to revise the federal estate tax rules have failed, but it's likely that major legislation will pass as early as this year. As a result, the future of the death tax remains one of life's great uncertainties.

On January 1, 2010, the estate tax phased out completely at the federal level. But on January 1, 2011, the estate tax returns at a top rate of 55% on estates worth more than \$1 million. The temporary "vanishing act" that unexpectedly occurred on January 1 is causing major problems for estate planners, and many expect Congress to revive the tax sometime this year, perhaps making it retroactive to January 1. Since the current rules make little sense and the government needs to raise taxes to reduce its massive deficit, everyone figures the current law will likely be changed.

While the chances of the estate tax being permanently repealed are less likely than ever, Congress may at least finally set some long-term clarity in this area. Until then, estate tax planning remains complex. The best solution is to review your estate tax status every couple of years. Stay tuned as we wait and watch to see what Congress does with its unfinished tax business.

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. ●



When Should You Amend A Tax Return?

Filing a tax return once is enough of a hassle. Doing an amended return for the same tax year—in other words, filing twice—seems like way too much. Yet millions of amended tax returns are filed by individual taxpayers each year.

Does an amended return increase your chance of being audited? Technically, no. But it will extend your exposure to IRS challenges. The agency can come after you for back taxes for up to three years from the date you file a return, and if you re-file, say, a year after the fact, that restarts the clock.

Still, filing an amended return can

put money in your pocket. So here are some of the most common reasons to file IRS Form 1040X.

You get an amended 1099, K-1, or W-2. These are forms sent to you by banks, brokerages, investment partnerships, employers, or others. It's not uncommon for these firms to make mistakes and resend a corrected form months after sending the original. And even if the corrected form will mean only a small change in your tax liability, you'll still need to file an amended return, since the government also receives a copy of revised forms and will match them to your return.

You're a sole proprietor, a

shareholder in an S-Corporation, or the owner of a partnership. As such, you may have strong incentives to file an amended return, since pension or profit-sharing plans for one year can oftentimes be funded with earnings from the following year. Say you receive a windfall prior to the due date for filing your return (excluding extensions), but after you already filed. You can use that windfall to increase your retirement plan funding for the prior year, retroactively giving yourself a larger deduction. You can reflect the change on an amended return.

You discover an overlooked deduction when checking through

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

your records, such as from a charitable contribution.

The law or IRS rules have changed.

Sometimes the IRS clarifies a rule or a court ruling will liberalize a tax break.

You miscalculated when figuring your tax liability for selling a mutual fund. Often, investors count only their original purchase

price as their cost, not realizing that reinvested income also qualifies. Your actual gain could be much lower than the amount you reported to the IRS.

In most cases, filing an amended

return will not be expensive. And if only one or two calculations have to be changed, it shouldn't be a big deal. No one likes to deal with the IRS and taxes, but you could be leaving money on the table by shunning a 1040X.

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

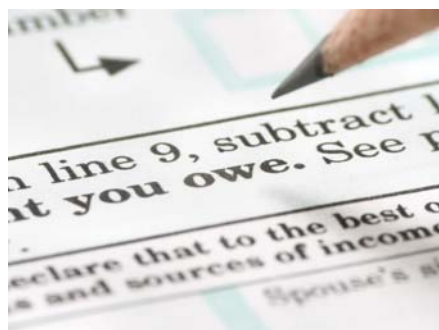
your estate without paying taxes. And there's more. You also get a lifetime gift-tax exemption of \$1 million. Any time you exceed the \$13,000 annual limit, the excess is counted against your exemption. So, for example, if you give your daughter \$25,000 this year, \$13,000 will be forever exempt from 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.●

To keep up-to-date on tax law changes affecting your taxes and your business, visit www.irs.gov or call 800 829-1040 (individuals) or 800 829-4933 (businesses).



Uncle Sam Changes Financial Aid Rules

The budgetary imbalance addressed by the Deficit Reduction Act of 2005 (signed into law in 2006) is, of course, the government's. But if paying college bills is in your future, this legislation could affect your family's budget, too. Changes made it easier for some students to qualify for financial aid. And if you or your kids borrow money to cover educational costs, you will save on loan origination fees and could ultimately benefit from a shift from fixed to variable interest rates.

New treatment of custodial accounts. The current federal financial aid formula makes a sharp distinction between student and parental assets. Students who have money held in their name in a custodial account—a UGMA (Uniform Gift to Minors Act) or UTMA (Uniform Transfer to Minors Act)—are expected to contribute 35% of the value of the account each year. So if your daughter has \$100,000 in a UGMA, the aid formula's

“expected family contribution” will include \$35,000 from the account. Parental assets, on the other hand, including funds held in a 529 plan established for a student, are assessed at only 5.64%. UGMA assets moved into a “custodial” 529 plan are also considered a parental asset, according to Joe Hurley, founder of Savingforcollege.com. But one custodial account drawback will remain after the transfer, Hurley notes. When your child reaches age 18 or 21, depending on your state, the account will still become the child's property.

A big break for prepaid tuition plans. A special type of 529 plan offered by 13 states lets you prepay your child's tuition at a state college or university. You pay what tuition costs now, and the state promises to pick up the much higher tab when your child matriculates. These plans come

with several restrictions and may not be the best way to save for college. But one of their biggest shortcomings, before the Deficit Reduction Act, involved financial aid. Any award had to be reduced dollar for dollar by a payment from a prepaid plan. Now, such money is treated like any other 529 asset, as a parental resource to be assessed at a maximum of 5.64%.

More predictable loan costs. Of course, if your income is high, your child isn't likely to qualify for need-based aid no matter where you hold your savings. That could mean taking a loan. The interest rate on Stafford loans, for students, is permanently fixed at 6.8%, while PLUS loans, for parents, have a fixed rate of 8.5%. Meanwhile, loan origination fees, which had been as high as 4% of the borrowed amount, are being phased out by 2010. ●



Roth IRA Conversion

(Continued from page 1)

ago, but in 2010, they are worth only \$400,000. At the top current income tax rate of 35%, that saves you \$35,000.

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

3. 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 after 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.

4. 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. ●

