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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

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Many Pre-Retirees Have Unrealistic Retirement Ideas

Five years after the MetLife Mature Market Institute conducted its first Retirement Income IQ Study, a follow-up survey shows a continuing lack of financial savvy among investors nearing retirement.

The 2008 survey, in April, questioned 1,216 people, ages 56 to 65. Results suggest more pre-retirees are aware that increasing longevity poses a major financial challenge. 56% of respondents correctly chose "longevity" as the biggest retirement risk, compared with 23% who gave that answer in 2003.

Respondents weren't so accurate on the other questions. Just 46% knew that retirement experts say most retirees will need 80% to 90% of pre-retirement income to maintain their lifestyles. Nearly half said they would need only 20% to 50%. And 69% overestimated how much money they will be able to draw from their savings while preserving the principal. Just 31% knew that a reasonably achievable average withdrawal rate was 4% a year, while the rest guessed 7%, 10%, or 15%.

Perhaps most disturbing, 38% believed their long-term care needs would be covered either by Medicare or their own health or disability insurance. None of those assumptions is true.

Other oft-overlooked retirement issues include the impact that inflation plays on outliving assets, and the fact that retirement assets, due to the taxation of distributions as ordinary income, get depleted much quicker than non-retirement assets.

Sincerely,

Robert J. Pyle, CFP, CFA

Gifting A Business Can Cut Estate Taxes

If you have a family business, transferring shares of it to your heirs now rather than at your death could help minimize disruptions to the company and save millions in potential gift and estate taxes. You don't have to give up your controlling interest. By retaining a majority of the stock, you can ensure that you always have a voice even when you retire. But if you think your business is about to take off, the time to get part of it out of your estate may be now, not later.

Gifts of Stock. Each year, a parent may give $13,000 to a child or other recipient without gift-tax consequences. In addition, everyone gets a $1 million lifetime gift-tax exemption. The annual exemption doesn't count against the lifetime cap.

Suppose you and your spouse own a business that you plan to take public next year and you'd like to transfer partial ownership to your two children before the initial public offering—after which, you hope, your stake in the business will skyrocket. Together, you and your spouse could give the kids a tax-free gift of stock worth up to $2,052,000—using up your full lifetime exemptions, plus the $13,000 each of you may give each child.

And the benefit? Suppose that rather than receiving the stock now as a gift, your children inherited it after you and your spouse have died. Estate tax laws are in flux, and it's impossible to say what their liability would be years or decades down the road. But under today's rules, if $2.052 million in stock had appreciated to, say, $20 million, the children might owe estate taxes of almost $8 million. (This assumes you and your spouse used a bypass trust to preserve your full estate-tax exemptions—currently $3.5 million for each of you for 2009.) By giving the stock now, you avoid any tax on the transfer.

Giving away partial ownership could provide an even greater advantage if you are transferring a minority stake in the form of illiquid stock. For tax purposes, your gift can be discounted. For example, if you gave your daughter a 40% stake in your $400,000 company, the discount could reduce its value by another 25% to 35%. That share of the company might be valued at just $104,000—40% of $400,000, discounted by 35%.

Gifts of Real Estate. You don't have to limit your gift to cash or stock; if your business owns real estate that either has a low tax basis or generates a lot of income, you can reduce your current income tax bill by shifting the ownership of these assets to family members in lower tax brackets and leasing the property from them. But you may want to give income-generating property only to adult children. For younger children (under age 19 or full-time students under age 24), the income is generally taxed at the parents' tax rate under the "kiddie" tax. ●

When Market Noise Gets Loud, Trust An IPS

The stock market often acts like a roller coaster with highs and lows during the year. When things are looking up, making money looks easy, worries about risk seem remote, and having a written investment policy statement (IPS) may feel like a waste of time and paper. When the market is in the dumps, the natural reaction is to sell, even though we all know the importance of "buying low." In both instances, an IPS will be your ally.

An investment policy statement commits to writing the details of your financial situation—what you want to accomplish, a plan for achieving it, and how much risk you're willing to take to get there. It can save you from your own worst instincts, helping you resist the temptation to reach too far when times are good or panic when the market plunges.

Suppose, hypothetically, that the Nasdaq Composite just had a great run, skyrocketing 15% in the most recent quarter. With your portfolio ahead just 5% during the period, you might feel frustrated, and tempted to grab some of Nasdaq's big gainers to try to catch up. A glance at your IPS, however, would remind you why that's a bad idea. The diversification strategy you've committed to is designed to keep your portfolio on a relatively even keel, with judicious allocations to bonds and dividend-paying blue chip stocks. It has the potential to produce steady gains over the long haul to fund your financial goals. And though it may not take off during a market surge, it's also less likely to go into free fall when the investment climate gets stormy.

While there's no hard-and-fast format for an investment policy statement, most combine the same basic components. First, there's usually an executive summary that lays out where you are now in your

IRS Ruling Boosts IDTs For Estate Planning

A new ruling by the IRS is expected to give a boost to a clever estate planning technique. The edict provides greater flexibility when using an "intentionally defective trust" (IDT) that shields assets from federal estate tax.

As the name implies, an IDT is structured expressly so that it will fail the "grantor trust" rules in order to realize certain tax benefits. Normally, you might transfer assets—such as cash, securities, or other income-producing property—to a trust that pays out annual income to designated beneficiaries. If you give up all rights to the assets, you won't have to pay income tax on the earnings. This can be particularly beneficial if you're already in a high federal income tax bracket. Instead of your paying income tax on earnings generated by the property, at a rate as high as 35%, the trust generally foots the tax bill.

But that can be counterproductive if you're trying to minimize the amount going to the IRS. Tax rates for trusts, as for individuals, begin at low rates (a minimum of 15% for trust income) but quickly move higher, with a 35% rate for trust income above $11,150 in 2009. So the trust could easily end up paying more tax on its income than you would have as an individual.

That's where an IDT can help. If the trust document is properly structured, the trust will be treated as a grantor trust, with language that allows you to retain certain rights and interests. One result will be that, as grantor, you'll be responsible for paying the tax on trust income—even though that money is going to the trust or its beneficiaries, rather than to you.

If you're already in the top personal income bracket, this move won't reduce the taxes paid on trust income, though the outlay will reduce the size of your estate and maximize the amount going to trust beneficiaries. But there could also be another benefit of establishing an IDT. With current interest rates very low, your potential gift tax for transferring property to the trust will be minimized. That liability is based on the amount the IRS believes will ultimately go to trust beneficiaries. The lower the current interest rate, the smaller that projected value of trust assets and the less gift tax you'll owe.

The estate tax rules for IDTs can present a thornier issue. Your taxable estate generally includes assets you've transferred to trusts and individuals if you have retained possession or enjoyment of the transferred property. That could apply to assets in an IDT, returning the assets to your estate and inflating the estate tax bill owed by your estate. Thanks to the new ruling, however—IRS Ruling 2008-22—there's a way you can maintain some power over assets transferred to an IDT without adverse estate tax consequences.

In the case that prompted the ruling, a grantor established and funded an irrevocable trust for the benefit of his descendants. The trust document specifically bars the grantor from serving as trustee. However, he retains the power, which he can exercise at any time, to acquire property in the trust by substituting other property of equivalent value. The grantor doesn't have to get the trustee's consent (or any other approval) before switching the property. He only has to certify in writing that both properties—the property originally transferred to the trust and the substitute property—are of equivalent value.

In its ruling, the IRS noted the grantor is not subject to the strict standards that would be required if he were a fiduciary of the trust. But it emphasized the significance of the requirement for using replacement property of equivalent value. That ensures he won't be able to decrease the value of the trust or increase the value of his personal holdings even though he retains the power to substitute trust assets. Furthermore, the trust is set up so it must have an independent trustee who will safeguard the rights of the beneficiaries. Based on these facts, the IRS ruled that although the grantor retained the power to use substitute property, trust assets would not be considered part of his gross estate.

This ruling gives grantors and their advisors more flexibility in structuring IDTs that can benefit the grantors' heirs. But these are sophisticated estate planning vehicles, and there are still plenty of pitfalls that could trip you up. If you think an IDT might help meet your family's needs, we can work with you and your attorney to gauge its potential benefits and avoid problems. ●

investing life. It describes your current portfolio and may include your target asset allocation, how much new money you'll invest each month or year, and what index benchmarks are used to gauge your progress. The executive summary also considers risk, often in terms of how much of a loss you could tolerate during specified time periods.

Next, your IPS may detail your investment objectives—for example, that you and your spouse plan to retire in 15 years, and you'll need income of $200,000 a year, inflation adjusted, for three decades. Your investment philosophy sets out your investing rules to live by. How do you feel about risk, diversification, frequency of trading, investment costs, and taxes? Answering these questions in a formal IPS provides a philosophical underpinning for specific investment selection criteria that translate your beliefs into action. Finally, the IPS may outline monitoring procedures for gauging your progress.

If you don't already have an investment policy statement, please let us help you create one. Simply going through the process can be invaluable; answering our questions about your goals and risk tolerance may focus your thinking in a new, beneficial way. And with your IPS in hand, we'll know how to serve your needs whatever the market climate. ●

College Savings Help Admission Chances

If you need a little extra motivation to set aside college savings each month, consider this: With a volatile stock market taking a bite out of college endowments, financial aid budgets are shrinking and assistance will be harder to come by. Worse, many colleges are choosing not to admit students who need aid.

Today, relatively few schools have the financial wherewithal to disregard a student's ability to pay when making admissions decisions. According to Donald E. Heller, an associate professor and senior research associate at Pennsylvania State University, only about three dozen colleges and universities now commit themselves to meet every admitted student's need. "So it's safe to conclude that all other institutions, to one extent or another, take financial need into account when deciding which students to admit," says Heller.

Will your children be affected? It depends on the strength of their credentials, Heller says. Most top candidates will be accepted regardless of need, and may even be awarded merit scholarships. But other students may be judged in part on the basis of how much they will cost the school. "When admissions staffs get down to those last pools of applicants, very often they will not admit students who need financial aid if they know the school can't meet that need," says Heller. "At that point, candidates who can pay their own way have an advantage."

That's not the way things generally worked during the 1970s and early 1980s, when most colleges at least aspired to need-blind admissions policies. By the mid-'80s, however, most admissions offices had adopted a more pragmatic business model often referred to as enrollment management. The bottom line for the admissions staff was simple: Fill the class but don't exceed the financial aid budget.

Today, enrollment management is firmly entrenched at most schools. Moreover, with economics affecting alumni giving and pressure being put on endowment earnings, a student's financial situation plays an increasingly critical role in the admissions process. As a result, strategies for maximizing a student's apparent need by putting assets in parents' names and taking advantage of aid formulas that require students to spend a larger proportion of their own savings could have undesirable consequences. And not saving for college at all, while counting on financial aid to bear the brunt of school costs, could prevent your children from getting into the colleges of their choice.

The safest approach to college funding is to plan to pay as much as possible yourself. Positioning your assets to qualify for financial aid or counting on the availability of loans could backfire with the admissions office and your kids. ●

Switch To Roth IRA

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home provide a $40,000 annual deduction for the next several years. The perfect use for that deduction, which 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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