The New Three-Legged Stool ...

October 2009

Volume 1 Issue 3

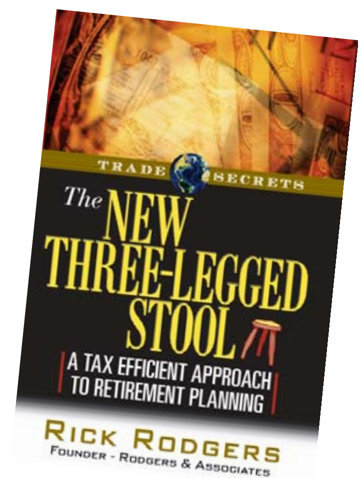
Update

Charitable IRA Distributions

In the dark final days of 2008 as the economy and the stock market were both tanking, Congress threw retirees a bone by placing a one-year moratorium on Required Minimum Distributions (RMDs) for those age 70 ½ or older. The purpose of the moratorium was to allow a retiree's Individual Retirement Account (IRA) to recover from the stock market sell off before they were forced to take a withdrawal. The moratorium is not much help for the retiree whose IRA is their only income source. They will need to continue withdrawals to pay living expenses. Those that don't need the money from their IRA for living expenses may want to consider taking money out anyway.

The first consideration should be to convert some portion of your IRA to a Roth this year when your taxable income will be lower because you don't have to take an RMD. This strategy has been covered in prior newsletters and extensively in my book The New Three-Legged Stool. Are there other reasons you might want to take an RMD in 2009?

(*Continued on Page 2*)



Inside this issue: Page

Charitable IRA Distributions 1
Naming A Beneficiary for your Roth IRA 1
Rick's Tip - When not to convert an IRA 4

Naming a Beneficiary for Your Roth IRA

Designating a Roth IRA beneficiary is almost an afterthought for most people. Lack of attention to this seemingly simple procedure can create costly tax impacts for beneficiaries.

The growth of Roth IRA values since they began in 1998 has been staggering. Many employers are starting to offer Roth 401(k)s as an option which will help Roth IRA balances grow even faster. Combine this with the elimination of income rules from Roth conversions in 2010 and it will not be uncommon to see seven figure Roth IRA accounts.

(Continued on Page 3)

Financial Planning Involves More Than Just Investments!

- Personal Goals
- Asset Allocation
- Tax Planning
- Tax Projections
- Estate Planning

Charitable IRA Distributions **(continued from page 1)**

Congress also passed another sliver of tax relief in those dark days of 2008 as part of the Wall Street bailout legislation. The Pension Protection Act of 2006 permitted a person over age 70 ½ to make up to $100,000 of charitable gifts directly from an IRA in 2006 and 2007. This provision was extended to 2008 and 2009 as part of the bailout package.

Normally, money from an IRA must be withdrawn from the IRA first, and then donated to a charity in order to get a tax deduction for a charitable contribution. The income generated by IRA withdrawals adds to the taxpayer's adjusted gross income (AGI). This could result in more of the retiree's Social Security income being taxed. It also reduced the amount of your medical deductions when you itemize. Miscellaneous deductions are also reduced.

For those that will be facing a RMD again in 2010 and who do not want nor need the money, there remains a unique opportunity to benefit a qualified charity by making a direct donation from the IRA to the charity without the donation adding to adjusted gross income and potentially increasing income taxes.

The itemized deductions allowed for the direct donation of cash to a qualified charity are limited to 50% of AGI for public charities and 30% for private foundations. A donor who wanted to give a larger amount but did not have a high enough AGI to allow the entire deduction could roll the excess deduction forward for up to five years.

With a direct IRA transfer, the deduction limitations do not apply for the IRA amount rolled over to the charity. No income is reported, so no deduction is required. And since no income is reported, AGI is not increased.

If the IRA owner's estate is likely to be subject to estate tax, this direct IRA transfer to a charity during their lifetime is an ideal way to get rid of excess money in the estate. When left in a taxable estate, the IRA is included in the estate total for taxation. After estate taxes have been paid on the total, IRA distributions are taxed again at the ordinary income tax rates of the heirs.

This direct rollover technique is an ideal way to benefit a qualifying charity while taking advantage of some potential tax breaks now, and saving taxes in the ultimate estate. Note that the gift must be made to a qualifying charity. Qualifying charities include most public 503(c) charities but do not include donor-advised funds, charitable-remainder trusts and private foundations.

"This provision was extended to 2008 and 2009 as part of the bailout package."

2009 and 2010 are full of opportunity!

****

You need to make sure you do this right. If you find this issue complex, call to schedule your free evaluation.

Naming a Beneficiary for your Roth IRA **(continued from page 1)**

The lost opportunities associated with Roth IRA distributions have largely been overlooked as investors have concentrated on filling the accounts. Now, as age catches up, investors will come face to face with the complex rules laid down by the IRS that can easily turn a golden nest egg full of tax-free income into an ordinary after-tax account.

Here are a few tips for Roth IRA distribution planning. To begin, it is helpful to understand taxation of Roth IRAs at the death of the owner. The income tax treatment of a Roth IRA following death is the same as before death, with these exceptions:

The 10% early distribution penalty generally does not apply to post-death distributions. It could apply to a spouse who elects to treat the Roth IRA as his/her own Roth IRA and subsequently takes a taxable distribution.

Beneficiaries can withdraw earnings tax-free, even if the beneficiary is under 59½ if the five-year requirement is satisfied. The five-year rule states that the income is not tax-free until it has been in the account for five tax years. Simply put, earnings can be withdrawn tax-free beginning on the first day of the fifth taxable year after the year the Roth IRA was established

Spouses who inherit a Roth IRA account from a recently deceased spouse have the option of rolling the Roth IRA into their own Roth IRA or leaving it in the name of their spouse. Spouses are not subject to the minimum distribution rules listed below.

Non-spousal beneficiaries of a Roth IRA must follow the same minimum distribution rules for inherited IRAs. The beneficiary has two choices, 1) receive the entire distribution by December 31st of the fifth year following the year of the owner's death, or 2) receive the entire distribution over your life expectancy.

There is little downside to electing the lifetime option because the beneficiary may take out more than the minimum at any time.

Roth IRAs have a special attraction for tax planning because they provide an envelope inside which the investments can grow tax-free (after satisfying the five-year rule). This envelope can be collapsed, causing an unwanted distribution within a year of the owner's death . . . and the loss of tax-free earnings over a lifetime if one of several mistakes is made.

For instance, if you name your estate as the beneficiary, the estate, which has no life expectancy, will have to distribute the account balance within the year. Failing to name a beneficiary of an IRA or pension account can cause the same unwanted results.

Roth IRAs are not completely tax-free at death. The federal estate tax applies to the assets you own at death which includes your Roth IRA. Your estate is subject to federal estate tax if it is worth more than the unused portion of your "unified credit amount" which is $3,500,000 for 2009. Roth IRAs don't enjoy any special exemption from the estate tax. If you own a Roth IRA at death and it passes to someone other than your spouse, it will be included in your taxable estate. Some states also have death taxes that would also include the value of a Roth IRA account.

There is one way Roth IRAs provide an estate tax benefit. Roth IRAs contain after-tax dollars. That means the size of your estate has been reduced by the amount of tax you paid on those dollars. The result is that you have a smaller taxable estate even though the value of what you're passing to your beneficiaries may be as great or greater than if you had a traditional IRA. This is an important consideration when deciding whether to convert your Traditional IRA to a Roth. That's why you may hear people say you receive estate tax savings from a Roth IRA. The estate tax savings come from the fact that you've already paid the income tax, not from any special estate tax rule that applies to Roth IRAs.

****

647 East Roseville Road
Lancaster, PA 17601

Phone: 717-560-3800
Toll Free 1-888-876-3437
E-mail: mark@rodgers-associates.com

NEED A SECOND OPINION?

Is your financial plan on track?

Are you satisfied with your current advisor?

Rodgers & Associates can help.

We offer a free telephone consultation to evaluate your current plan and offer suggestions on how to improve it.

Call Mark Eisenberger at (888) 876-3437 or email him: Mark@Rodgers-Associates.com to make arrangements for a free, no obligation consultation.

Rick's Tips - When Not to Convert to a Roth

I've written so much about making Roth conversions the past couple of months that people have begun to ask me if there is ever a reason not to convert. The answer is yes. So in this issue of the newsletter, I want to take you through the thought process.

We begin with the basic principle that it is always better to pay less tax than to pay more. In other words, I don't want to pay 30% in taxes on a Roth conversion today if I am reasonably sure I will be able to pay 15% tax in the future. My belief that tax rates will be going up for most Americans in the future is driving my push to do Roth conversions. However, I know that everyone will not pay higher tax rates in future years.

An important part of the Roth conversion decision process will involve making forecasts about future tax rates and compare them to your current tax rate. The place to start is to calculate your income needs in retirement.

Let's use a hypothetical income target of $100,000. Using *The New Three-Legged Stool* approach to planning, you will want some of this income to come from your Roth, your IRA/401(k), and your after-tax savings. Your after-tax investments should all be in stock investments. Historically, stock investments have generated 3% in dividends and 7% in capital gains. Use these numbers to estimate the taxable income from your after-tax accounts. You will be able to control the taxable income from your IRA/401(k) by the amount of the withdrawals you take each year (at least until you reach age 70 ½).

The maximum amount of taxable income for a taxpayer filing jointly to stay in a 15% tax bracket is $67,900 in 2009. Tax brackets are typically increased by the rate of inflation each year. You could use a 3% inflation factor to estimate your bracket in the future. Anyone in a 25% tax bracket now that estimates they may be in a 15% bracket in the near future may not want to do Roth conversions now.

Forecasting what Congress may or may not do with taxes in the future is risky. Higher taxes are undoubtedly on the way as the government looks for ways to reduce budget deficits. This doesn't necessarily mean it will be in the way of higher income taxes. A national sales tax and a value added tax have been debated in the past. Neither of these taxes would have an impact on IRA withdrawals. There is also the possibility that current retirees would be exempt from tax increases affecting IRA withdrawals. Roth conversions should be approached conservatively for those that are near retirement. Those who are younger and thus have many years of tax free growth ahead of them in a Roth can be more aggressive.

****

Information and examples in this article are of a general nature. The information reflects the opinion of Rick Rodgers and Rodgers & Associates on the date written and is subject to change at any time without notice. Due to various factors, including changing market, tax, and legal considerations, the content may no longer be reflective of current opinions or positions. The information provided should not be deemed to constitute financial, investment, tax or legal advice.