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How The New Tax Reform Legislation Benefits You

The new Tax Increase Prevention and Reconciliation Act (TIPRA) alters the Internal Revenue Code in ways distinctly friendly to taxpayers. But one of the most potentially advantageous new rules doesn't kick in for years, and could be repealed before ever taking effect. Two other modifications, though, translate into immediate tax savings, and the laggard, effective in 2010, could have major long-term significance.

That potent change enables every taxpayer, regardless of earnings, to convert a traditional individual retirement account into a Roth IRA beginning January 1, 2010. Until then, individuals with incomes exceeding $100,000 can't make the conversion.

Roth IRAs were created in 1997 to let investors accumulate wealth on a tax-free basis. Funds have to stay in the account for five years before earnings attain tax-free status, but unlike regular IRAs that require you to take out money beginning at age 70½, a Roth never forces distributions. And if you leave a Roth IRA to heirs, though they must make specified annual withdrawals, those distributions are tax-free.

Who should convert? It makes the most sense if you don't plan to tap the account for some time and, when you begin withdrawals, you expect your tax bracket to be the same or higher than when you converted the account. Transforming an IRA into a Roth requires paying tax at your ordinary rate on the account's current value, minus any non-deductible contributions. Converting makes sense only if the tax-free growth afterwards compensates for the up-front tax hit.

That's more likely if taxes you save later are at least as high as you would pay now on the conversion. But gauging the tradeoffs involves not only current and future tax rates but also projected investment returns and the length of time you and your heirs expect to let the account assets build.

New rules will make converting to a tax-free Roth IRA more common

How much you pay to convert is also key. You may be able to offset some or all of a conversion's income by taking losses or deductions that year. Moreover, converting in 2010 offers flexibility not available later. You can declare the entire taxable amount on your 2010 return, or you can pay tax on half in 2011 and the rest in 2012. But even then, there's a fly in the ointment. In 2011, tax rates are slated to return to higher, pre-2001 levels. Thoughtful planning is critical.

It's also wise to begin mulling how to pay the tax. Taking money out of the account, besides

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Fit For The Job? Let's Walk And See...

Have you ever found yourself digging through the freezer looking for your favorite treat? Well, your team here at FSA is no different. At any given time, we've had no shortage of ice cream, popsicles, chocolate this, chocolate that, or just about any other type of sweet to satisfy the craving. Gluttony no more!

In an attempt to curb the craving, we have adopted a wellness program to minimize the trips to the "ice box of sin." It starts with a pedometer – counting the steps we take every day. You can even find some folks marching in step or dancing in the hallway (we've got pictures.)

Some of those pictures introduce the newest member of our team, Stephanie Bonte-Lebair. Stephanie started with us on July 5th and is an Executive Assistant to Dave and myself. She comes with several years of experience in the legal profession. As she organizes our lives and manages our calendars, please don't hesitate to call her to schedule a review. She welcomes the opportunity to talk with you.

A couple articles in this issue deal with estate planning. That is, what are some things you can do today to ensure security tomorrow; whether it's finding someone to act on your behalf in the event you become disabled or setting up the correct trusts to make certain your estate is handled correctly. Also read about the recent tax reform and the benefits that come with it. Enjoy!

Jim Joseph
Client Relations Manager

Inheriting A Spouse's Estate: Understanding

Nothing can erase the emotional havoc you feel when you lose a spouse. But recent changes in IRS laws may help alleviate financial burdens, and understanding the maze of complicated rules for inheritors could help you feel more at ease about your future. Here are several considerations we can review with you.

Maximizing retirement benefits. If you're the beneficiary of your spouse's 401(k), IRA, or other retirement plan, that money is paid directly to you after the death. But keeping it may mean a significant income tax bill. If, instead, you roll over funds to your existing IRA, the money can continue to grow tax-deferred. However, if your spouse had begun taking required minimum distributions (RMDs) from the account—but not during the year he or she died—you'll have to take that RMD before the end of the year.

Another option is to put the money in a new IRA naming your deceased spouse as account owner and you as beneficiary. This may offer extra perks. For instance, if you're not yet 59½, you can withdraw funds without triggering the normal 10% early withdrawal penalty, which doesn't apply to death benefits. Or, if you're older than your spouse and have started taking RMDs from your own IRA, you can leave funds in the inherited IRA until the end of the year in which your spouse would have turned 70½.

Regulatory Update
Until recently, taking the RMD the year of a spouse's death meant you surrendered the right to disclaim an IRA. Then came Ruling 2003-36, which says you can take the RMD the year of death and still disclaim some or all of the balance until September 30 of the following year.

If you're financially comfortable, consider disclaiming (forfeiting ownership of) all or part of the IRA to contingent beneficiaries, who may be younger and could get a disproportionate benefit from long-term compounding. For example, if you disclaimed $100,000 each to your 40-year-old son and 10-year-old granddaughter—and if their only withdrawals were RMDs that continued through their expected lifespans—total pre-tax distributions for the 40-year old could be almost $794,000, and, for the 10-year-old, more than $4.6 million, according to data from T. Rowe Price.

Leveraging trusts' benefits. Spouses benefit from an unlimited marital deduction that lets you inherit any amount from your spouse estate-tax free, provided you're a U.S. citizen. Yet your heirs could be on the hook. Trusts you and your spouse set up could relieve their burden, too.

● If you and your spouse established a credit shelter trust (CST), also called a bypass trust, specified assets passed into the trust at his or her death. You can tap these funds to pay health, education, or other expenses. But because the money went into the trust rather than directly to you, your heirs get the benefit of your spouse's estate tax exclusion, an amount all individuals are entitled to shield from estate taxes.

Suppose you and your spouse jointly own $2 million in assets and your spouse separately has $2 million. While you can inherit all $4 million tax free, your children or other beneficiaries may owe taxes after your death. Their tax bill will be reduced by your estate tax exclusion, the size of which depends on when you die. From 2006 through 2008, you can pass on $2 million tax free, and in 2009, the exclusion rises to $3.5 million. In 2010, there's no estate tax, but in 2011, the exclusion is scheduled to drop to $1 million.

A CST is usually structured so that, when the first spouse dies, an amount matching that year's

Who Would Pay Your Bills, If You Were To Become Disabled?

What would happen to you if you became disabled or incapable of caring for your financial affairs? Who would pay your bills? Who would make crucial estate planning decisions? Who would execute trusts and make other important financial choices on your behalf?

If you don't have answers to those questions, you need to know about a legal instrument called a durable power of attorney, or DPOA. Establishing a DPOA probably isn't as high on your must-do list as, say, writing a will. But the DPOA may be even more important. While a will can help your loved ones after you're gone, you may need a DPOA when you're alive and most vulnerable.

Creating a DPOA is generally a job for an attorney, who can write your will and health-care proxy at the same time. A DPOA is similar to a health-care proxy in that both give someone you trust the right to make decisions for you under circumstances that you specify.

Some states permit two types of DPOA: a "springing" power of attorney that becomes effective only when you become incapacitated, and a "general" power that is effective the moment you sign it—even if you are in good health. Some people, who balk at the idea of giving even a trusted friend carte blanche to make financial decisions, may favor a springing power. With a springing power, however, if you are in a car accident or otherwise suddenly become incapacitated, a doctor must certify that you aren't able to make your own decisions. And physicians are sometimes reluctant to do that for fear of becoming enmeshed in a family struggle for your assets.

To solve this problem, you could establish a durable power that names two agents and requires them to act

IRS Rules And A Maze Of Choices

maximum estate tax exclusion goes into the trust, thus making full use of that spouse's individual exemption. Then, at your death, the trust assets pass tax free to the trust's beneficiaries, while the taxable amount you pass along is reduced by your own exclusion. Without the trust, your kids would benefit from only one exclusion.

● Many types of marital trusts allow your spouse to specify who will receive his or her property after your death while still offering you extra income during your lifetime. If your spouse has children from a prior marriage, for example, he or she may have established a qualified terminal interest property (QTIP) trust to ensure they receive their share of the estate.

Ask your attorney to review with you the language in all trust documents to make sure you understand the terms and the level of support you may receive.

Slimming down capital gains. If you sell inherited assets, you may owe capital gains tax. The good news is that under current rules, an asset's value is "stepped up" to the market value at a spouse's death, meaning you'll be taxed only on profits exceeding what the asset was worth when you inherited it. For example, if you receive stock worth $5 million, it won't matter that your spouse bought it for $100,000. You'll still be taxed only on proceeds beyond $5 million.

But that tax break ends in 2010, along with the estate tax. If you inherit and sell assets that year, your tax bill could be based on the assets' original purchase price. But all inheritors will be able to increase the tax basis of total inherited assets by a maximum of $1.3 million, and surviving spouses can further inflate the basis by up to $3 million. So if you inherit that $5 million stock your spouse purchased for $100,000, your capital gains will be based on a new tax basis of $4.4 million ($100,000 original basis + $1,300,000 step-up + $3 million spousal provision).

Property given or transferred to your spouse within three years of his or her death, as well as some foreign investments, won't qualify for the 2010 step-up rules.

Knowing the rules of property ownership. If you and your spouse owned property through a joint tenancy with survivorship arrangement—that is, you held property such as real estate, motor vehicles, checking or savings accounts, or government bonds together in equal, undivided shares—you become the owner of that property at your spouse's death.

Joint tenancy is a common strategy for avoiding probate. But owning assets in this way means you can't preserve your spouse's estate tax exclusion.

Only the final survivor in a joint tenancy contract may dispose of the property through a will. So it's important for you to provide in your will for the entire property to be passed along to specified beneficiaries. Otherwise, it will go to your heirs in acccordance with state law.

If you reside in a community property state—Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin—assets acquired during marriage are divided equally after a spouse's death. Each owner may decide who will inherit his or her share of the assets. Establishing a joint tenancy arrangement in a community property state is possible, but complex. You may be allowed only half the step-up basis when you sell, because you technically own only half the assets.

Filing your tax return. You can file a joint return in the year of your spouse's death, unless you remarried during that calendar year, or you could file separately. In addition, if you support a dependent child for whom you can claim a tax exemption, and you haven't remarried, you could file as a "qualifying widow(er)"—equivalent to a joint filer—for two years after your spouse's death.

Be sure to indicate ***"Deceased"*** across the top of a joint return, along with your spouse's name and date of death. As a surviving spouse, you get an additional $1,250 deduction.

These are complex rules, and we know this is a challenging time for you. Always feel welcome to contact us about any concerns you may have.●

If You're Not Sure, Here's An Idea

jointly on your behalf. Putting your financial decision-making in the hands of two people you trust should eliminate any fear of wrongdoing.

You could write a DPOA yourself, using software or forms available in an office supply store. However, the boilerplate language of do-it-yourself solutions may not cover all of the situations that your document should address. For instance, your DPOA could allow your agent to make gifts of your assets to family members if you become incapacitated. Such gifts or transfers to a trust could allow you to qualify for government assistance in a nursing home without first having to deplete all your assets. Even if you are married, your spouse can make decisions only about assets that you hold jointly. A DPOA could allow your spouse or another agent to manage the assets that aren't held jointly.

These days, with life expectancies lengthening and Alzheimer's Disease on the rise, DPOAs have become an essential financial planning document. And they are not just for the old or infirm. A DPOA can protect anyone who becomes suddenly disabled or incompetent, even if just for a temporary period. ●

The Ethical Will: How To Leave Your Wisdom

You are far more than the sum of your possessions. Yet when it comes to bequests, your last will and testament probably deals just with concrete assets. What happens to the intangibles: the wisdom, values, experiences, and stories you've accumulated over the years?

Enter the ethical will. In its simplest form, an ethical will sets forth the moral and spiritual "capital" you may want to leave to the next generation. While not a legal document, this message to your heirs is often recommended by attorneys and financial advisors as a tool for establishing a family legacy built on pillars you hold dear.

Almost anything can go into an ethical will. Some people pass along the life lessons they've learned over the years. Others articulate specific moral values, describe mistakes they've learned from, fill in the context surrounding major events of their lives, articulate spiritual beliefs, recommend meaningful books, share funny experiences, and express their love. Some even ask or bestow forgiveness. Though in many cases, those for whom ethical wills are intended—family, friends, even organizations—have heard these insights before, this sets them down in a tangible, immutable form.

With today's technology, creators of ethical wills are no longer confined to acid-free paper and fade-resistant ink (both are recommended if you do use pen and paper). You can not only record your wishes on audiotape, but create an entire DVD, complete with video clips, photographs, navigation, and music. This allows loved ones to read your words and pick up your inflections, adding shades of meaning to your message.

The benefits, however, are not just for those left behind. Many of those who draw up an ethical will find it gives them a deeper, clearer understanding of their own value systems or life stories. That's an argument for creating one well before the end of life. A couple could use this tool to learn more about each other before the wedding, or as they start a family. Those in midlife or about to retire could use an ethical will to clarify the direction for the next stage of their life.

Families in business together might also benefit from creating ethical wills. All too often, after the death of the parent who ran the company, heirs will bicker about a business's future direction, frequently invoking "what Mom and Dad would want." An ethical will, thoughtfully set forth by the head of the family, can give descendants a shared framework and clarify the business's original values.

There's no fee or formal process to create an ethical will. Just carefully reflect on what you want to say to those dear to you, and then create your will in any form or format that appeals to you. This simple, straightforward act could have a profound impact on generations to come.

To find out more about why and how to make an ethical will—including examples for each life stage—visit www.ethicalwill.com. ●

New Tax Rule Benefits

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diminishing what's left to accumulate tax-free, triggers a 10% penalty if you are not yet age 59½. So it's better to locate another source of funds.

Finally, the new rule presents an opportunity if you earn too much to contribute to a Roth each year (the cut-off is $160,000 if married, $110,000 if single). You might consider making non-deductible contributions to a traditional IRA starting this year, with the goal of flipping the account to a Roth come 2010. Tax would be due only on the earnings in the account. The maximum contribution in 2006 is $4,000 (plus $1,000 more if you are at least age 50), and it rises to $5,000 in 2008. When you make non-deductible IRA contributions, you must file IRS Form 8606 along with your tax return.

A second important TIPRA change is the extension, through December 31, 2010, of the 15% tax rate on qualified dividends and long-term capital gains (profits on investments held more than one year). Meanwhile, investors in the lowest income brackets pay no tax on a portion of their gains in 2008 through 2010. Under prior law, these attractive rates were set to expire at the end of '08, after which capital gains would again be taxed at 20% and dividends would be treated as ordinary income. TIPRA's extension provides additional incentive for holding growth assets and dividend-paying stocks in taxable accounts, to benefit from low rates, while utilizing tax-deferred accounts for investments that generate interest, which shoulders the highest tax rate.

Finally, the new law provides some relief from the alternative minimum tax for 2006. TIPRA's increase in the amount that's exempt from AMT—up to $62,550 for joint filers and $42,500 for single—will save an estimated 15 million taxpayers from owing the alternative tax. Although this AMT tax break applies only in 2006, Congress has now bumped up the AMT exemption four times in the past five years—further reason for keeping your eye on the ball when it comes to tax planning. ●