JOEL ISAACSON & CO., LLC

FINANCIAL AND TAX PLANNING

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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may be tax deductible, but the amount you deduct and subsequent earnings will be fully taxed as income when withdrawn during retirement.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 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

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A "Lost Decade?" For Index-Only Investors, Maybe

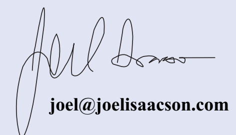
The S&P 500 finished a tumultuous 2009 up 26.5%, rallying over 60% from its March low. Still, the index is down 9.11% over the last 10 years, which pundits are calling a "lost decade."

From 2000 to 2002, stock prices fell 43%, followed by a strong five-year rally and then another plunge in the market crisis of 2008 and early 2009. But while stocks lost ground, a balanced portfolio would have fared far better. Most of our active equity and fixed income managers handily beat their indices over this period.

As we look towards 2010, we are cautiously optimistic that the worst of the crisis is behind us. While significant headwinds (unemployment, housing, political and regulatory battles, etc.) still exist, we continue to see an increasing number of positive economic reports reflecting a recovery underway.

We are confident that we can work together with you to ensure that your long-term financial plans stay on track. We thank you for your continued confidence in us and wish you and your families a happy, healthy, and prosperous New Year.

We have recently updated our Form ADV on file with the SEC. In keeping with Rule 204-3 of the Investment Advisors Act of 1940, we offer our clients a copy of the Part II disclosure form. Please contact Tracy Iovino (tracy@joelisaacson.com) if you would like a copy.



joel@joelisaacson.com

Do You Really Need That Inheritance?

Sometimes it pays just to say "no thanks" to a generous bequest—even from your own spouse. There may be estate planning benefits to having the assets go directly to contingent beneficiaries named by the decedent. If those beneficiaries are your children, this strategy could help them keep more of the bequest.

Officially declining an inheritance involves executing a legal document known as a "qualified disclaimer." This refusal, which can apply to all or part of a bequest, must be executed within nine months of the donor's death and before you've received any income from the inheritance. While this is generally a reactive measure, similar results can be obtained setting up a disclaimer trust as part of your estate plan.

One factor in deciding whether to refuse an inheritance is the uncertain future of the federal estate tax. Currently repealed for 2010, it is scheduled to be revived in 2011 under unfavorable conditions.

The amount of an estate that's exempt from federal tax, which was gradually increased to $3.5 million for those who died in 2009, will drop back to $1 million for 2011, unless Congress enacts new legislation.

Also, after gradually being reduced to 45%, the top estate tax rate will return to 55%. The Obama administration and Congress will likely adjust the rules or change the timetable, but most experts expect the estate tax to continue to exist in some form. A qualified disclaimer or a disclaimer trust could help you prepare for whatever comes.

Suppose that under your current will, all of your assets are to go to your spouse if you die first, and vice versa. Then, at the death of the surviving spouse, the remaining assets will be divided among your children. With this arrangement, there's no estate tax due after the first death—because a spouse can inherit an unlimited amount tax free—and the surviving spouse's estate can be reduced, for tax purposes, by whatever individual exemption is in effect at the time.

But this wastes the exemption of the first spouse to die. Instead, the surviving spouse could disclaim an amount equal to the estate tax exemption, passing it directly to contingent beneficiaries. The first spouse's exemption relieves the heirs of any current estate tax liability, and later the surviving spouse's own exemption can be used.

Before disclaiming any assets, one's current and future potential need for the disclaimed assets should be carefully analyzed by a financial planner, since this is an irrevocable decision. We can work with you and your attorney to consider whether turning down an inheritance might make sense for you, and help you follow the rules that govern the process.

Also, if your net worth nears or exceeds federal estate tax exemption limits, we can discuss how setting up a disclaimer trust now can benefit your heirs. ●

Financial Tips For Those Out Of Work

The numbers are scary. From December 2007 through October 2009, unemployment in the U.S. doubled from 7.6 million to 15.1 million. But the statistic that matters most is your own, and if you've been laid off or your company has gone under, you're competing with an army of others for the few available jobs. Still, manage your financial affairs carefully and you'll certainly survive the economic crisis. You might even emerge in better shape than you were before. These eight suggestions could help.

1. Don't panic. It's normal to be nervous if you've suddenly been sent packing after years of gainful employment. But now's the time to take stock of your situation as calmly as possible. Keeping your emotions under control will make it easier to find the way forward.

2. Reduce spending. Food and shelter are necessities, but other purchases are discretionary. Consider ways to trim your cable TV bill and think twice about dining out. Finding things you can do without may also help you overcome the feeling of powerlessness that often comes with unemployment.

3. Eliminate unnecessary debt. Cut up your credit cards? Maybe not, but charge only what you can afford to repay each month. Otherwise, a small debt could quickly spiral out of control.

4. Take advantage of benefits. These days, you can likely avoid those dispiriting visits to the unemployment office and apply for jobless benefits by mail or online. And if you need to continue your health insurance coverage under COBRA, a provision of the American Recovery and Reinvestment Act of 2009 will subsidize 65% of the cost for nine months.

5. Network, network, network. Applying for posted jobs pits you against a host of other applicants. You may do better reaching out to friends, family, and business associates. Be

Help Loved Ones With Tax-Free Gifts

Today's severe economic crisis is taking its toll on virtually every segment of the population. Young newlyweds are finding it difficult to set aside funds for the down payment on a home, despite the now lower prices. Middle-aged parents are struggling to make ends meet and still squirrel away cash for their children's college costs. And older workers and retirees have seen their nest eggs eroded by the recent stock market downturn.

If you've been fortunate (and foresighted) enough to escape major damage to your own finances, you may want to consider helping family members overcome economic hurdles. Providing tax-free gifts could improve their situations while benefiting your own estate planning as well. If you stay within tax law boundaries, you don't have to pay gift tax on cash or property transferred to relatives or any other recipient. At the same time, the gifts will reduce the size of your taxable estate.

The value of the latter benefit depends on the future of the federal estate tax, which remains uncertain. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), called for the outright repeal of the estate tax in 2010. But that provision of the legislation expires at the end of 2010, and in 2011, pre-EGTRRA rules return. The estate tax exemption is scheduled to revert to just $1 million, and the estate tax rate will rebound to 55% unless Congress acts to change the law.

While a legislative compromise on the estate tax is likely, the tax will almost certainly continue in some form. And that likelihood only increases the appeal of making gifts now to help loved ones hurt by the recession. In 2010, you can provide tax-free gifts of as much as $13,000—in any combination of cash and property—to as many recipients as you choose. You don't even have to file any tax forms or otherwise inform the IRS about such gifts (if those are the only gifts made and unless gift splitting with a spouse is elected).

The chance to provide unlimited numbers of tax-free gifts could multiply the benefits not only for recipients but also to your estate plan. For instance, if you have two children and three grandchildren, giving each of them $13,000 in 2010 adds up to a total of $65,000. If your spouse also makes such gifts (or consents to a joint gift by filing a gift tax return), that exemption jumps to $26,000 per relative and a total of $130,000 for five, all without gift-tax consequences. Continue this gift-giving program for five years and you'll have cut the value of your estate by $650,000 while providing generous assistance at a time when it may be sorely needed.

If the recipient is in a lower tax bracket, gifting shares of stock, mutual funds, or other assets that have appreciated will save you from paying capital gains taxes. But if you have assets with unrealized losses that you want to donate, it's better to sell them first so that you can deduct the loss on your tax return and give your gift in cash.

If you exceed the annual limit on tax-free gifts, you still won't necessarily owe money to the IRS. But larger gifts would count against your lifetime $1 million gift-tax exemption, which might be put to better use in funding trusts or for other estate planning purposes. Plus, you'll have to file a gift tax return—or potentially two gift tax returns if you're married.

Meanwhile, there are two special situations in which the normal giving limits don't apply. The first involves money you provide directly to an educational institution on behalf of a student. The second is for direct payments to health care providers.

The unlimited exemption for education payments means you won't owe gift tax if you cover college costs for children or grandchildren. Suppose your granddaughter is attending an Ivy League institution and the annual bill for tuition is $50,000. You can pay that amount directly to the university and still give her an additional $13,000 gift (or $26,000 with your spouse) that won't be subject to gift tax.

If children or grandchildren are still years away from college, an even better approach might be to fund a Section 529 college savings plan that names the child as beneficiary. Income earned by plan investments won't be taxed, and withdrawals to pay qualified educational expenses will also be tax-free. Plus, a special provision allows five years' gifts to be sent to a 529 plan in one fell swoop. That means you and your spouse could immediately provide $130,000 to jump-start a 529 plan without gift-tax consequences (provided you file a gift tax return to elect to front-load the gift). ●

casual—you don't want to seem desperate—but be sure they know you're job hunting.

6. Consider a career change. If your industry or profession seems unlikely to rebound, you might broaden your search to include related fields—from print media, say, to work on a website, in public relations, or in another job requiring writing and editing.

7. Start a new business. If you've always dreamed of turning a hobby or other passion into a profitable business, this might give you the push you need to go for it. If you can fill a niche with high-quality services or products while keeping startup costs low, you'll stand a good chance of success.

8. Stay positive. An extended job search may sap the energy you had when you were first laid off. But perseverance will pay off. And remember: If you're middle-aged or near retirement, your wealth of experience is an asset, not a liability.

Finally, in a pinch, you may need to tap your retirement plans. But money you pull out now will be difficult to recoup later on, so consider this option only for emergency purposes. ●

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

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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 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. ●

Joel Isaacson & Co., LLC 546 Fifth Avenue, New York, New York 10036

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