113 West Chestnut Street, Suite 202
West Chester, PA 19380
Phone: 610-719-0615
Fax: 610-719-0616
EMail: stilesed@retire-me.com

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Edward D. Stiles

RETIREMENT
INSIGHTS

WINTER 2010

The Benefits of Roths

> "A recent study reveals that today's preretirees will need to postpone retirement by 4.2 years on average to make up for losses caused by the housing market and stock market."
>
> Source: Age Wave, 2009

The Roth individual retirement account (IRA) has been an attractive retirement savings option since its inception in 1998. However, income eligibility restrictions have prevented many higher-income individuals from using this savings vehicle. Two recent developments are changing that — the removal of income limitations for Roth IRA conversions and tax laws making the Roth 401(k) permanent.

2010 Roth Conversions

Starting in 2010, all taxpayers, regardless of the amount of their adjusted gross income (AGI), can convert from a traditional IRA to a Roth IRA. Before 2010, your AGI cannot exceed $100,000 to convert, not including any income resulting from the conversion. Amounts converted must be included in income if taxable when withdrawn (i.e., contributions and earnings in deductible IRAs and earnings in nondeductible IRAs), but are exempt from the 10% early withdrawal penalty.

If you make a conversion in 2010, the tax can be paid in two installments in 2011 and 2012, with no tax due in 2010. However, if you prefer, you can elect to pay the tax in 2010, which may make sense if the current lower tax rates are not extended beyond 2010 or you expect much higher income in 2011 or 2012. Taxes on conversions made after 2010 must be paid in the year of conversion.

Permanent Roth 401(k)s

Originally, Roth 401(k)s were scheduled to expire in 2010, so many companies were not willing to start a plan that would expire after a few years. However, the Pension Protection Act of 2006 made Roth 401(k)s permanent, which should help spread their use.

The Roth 401(k) is patterned after the Roth IRA — contributions are made from after-tax earnings that grow tax free, and qualified distributions are withdrawn tax free. Employees eligible for their employer's 401(k) plan are also eligible for the Roth 401(k). There are no income limitations for contributions to a Roth 401(k), with contribution limits of $16,500 in 2009 and 2010 plus a $5,500 catch-up contribution for those age 50 and over, if permitted by the plan. Contributions can be split between a regular and Roth 401(k), as long as total contributions do not exceed the maximum. Funds contributed to each type must be held in separate accounts. Any matching contributions made by the employer must be held in the regular 401(k) account, so they will be

Continued on page 3

Planning Opportunities Reduced for Vacation Homes

In the past, it was possible to turn a vacation home or rental home into your principal residence so that you could later sell it and exclude gains on the sale from income. If you were planning on such a strategy, be aware that the tax rules recently changed.

Prior to the tax law change, you could purchase a vacation home or rental property years before you retired. Once you retired, you could sell your principal residence. As long as you lived in that home for two of the last five years before selling, you could

Continued on page 2

Planning Opportunities Reduced

Continued from page 1

then sell the home and exclude up to $250,000 of gain if you are single and up to $500,000 of gain if you are married filing jointly. After that, you could move into your vacation home and use it as your principal residence. Then, as long as you had lived in the vacation home at least two of the last five years before selling, you could sell that home and exclude the gain up to the limits noted above.

The new law now separates holding periods into qualified and nonqualified use. When a home is sold, the gain must be allocated between qualified and nonqualified use, with the portion of the gain related to nonqualified use included in taxable income.

The law was effective after December 31, 2008. Qualified holding periods include:

- ✔ Holding periods prior to January 1, 2009;
- ✔ Holding periods after January 1, 2009, if the taxpayer uses the residence as his/her principal residence; and
- ✔ Any portion of the five-year period after the taxpayer's use of the property as a principal residence, provided the home is sold within that five-year period.

To count as qualified use, the home must be used as the principal residence by the taxpayer, the taxpayer's spouse, or the taxpayer's former spouse. A temporary absence from the home for reasons of employment, health, or unforeseen circumstances not exceeding two years does not count as nonqualified use. Any period up to 10 years that the taxpayer or the taxpayer's spouse is serving on extended military duty also does not count as nonqualified use.

When a principal residence with nonqualified use is sold, even if the home has served as the principal residence for two of the last five years preceding the sale, any gain must be allocated between qualified and nonqualified use. Gains related to nonqualified use must be included in income, taxable at capital gains rates as long as the home was held over one year.

Thus, starting in 2009, there is no tax benefit to taxpayers to purchase a vacation home that will later be converted to a principal residence. For those who already own vacation homes, the longer the pre-2009 holding period and the sooner the vacation home is converted to a principal residence, the better for the taxpayer. ✔✔✔

Unemployment in the Current Recession

With unemployment rates higher than they've been in decades, many are trying to determine how quickly unemployment numbers will come down once the recession is over. Researchers focus on two components of the unemployment rate — the inflow rate, or the rate that workers are moving into unemployment, and the outflow rate, or the rate that workers are moving out of unemployment. The movement of these two rates has varied over time.

During recessions in the 1970s and 1980s, employees were getting fired and were unable to find new jobs because employers were not hiring. This caused large spikes in the overall unemployment rate. However, once the economy turned around, the inflow and outflow rates returned to normal levels, bringing the unemployment rate down quickly.

But during the 1991 and 2001 recessions, unemployment rates spiked up primarily due to lack of hiring, not due to massive layoffs. As the economy started to recover, employers were slow to hire, creating jobless recoveries.

During the current recession, the labor markets are again more typical of recessions in the 1970s and 1980s, with high levels of firing and low levels of hiring. That makes it much more difficult for unemployed workers to find jobs, increasing the length of time people remain unemployed.

To try to determine how much hiring employers will do once the economy starts to recover, a couple of other indicators can be reviewed. During recessions, the number of temporary layoffs and the number of involuntary part-time workers typically increases. However, during this recession, there are more permanent rather than temporary layoffs, meaning that employers do not intend to rehire these employees in the near future. For instance, between July 1981 and November 1982, the percentage of unemployed workers on temporary layoffs increased from 16.1% to 20.7%. From December 2007 to April 2009, the percentage declined from 12.8% to 11.9% (Source: *FRBSF Economic Letter*, June 5, 2009).

The number of employees who are working part-time involuntarily is at historical highs, increasing from 3.0% in December 2007 to 5.8% in April 2009 (Source: *FRBSF Economic Letter*, June 5, 2009). This increase has occurred in a broad range of industries in a wide range of occupations. Many see this as a sign that once the economy recovers, employers will just move employees from part-time to full-time status without the need to hire more employees.

While no one knows for sure what will happen in the future, all of these factors imply that even when the economy starts to recover, unemployment rates may stay at high levels for some time to come. ✔✔✔

Is a 401(k) Plan Enough?

If you work at a company that offers a 401(k) plan, especially if the plan offers matching contributions, that 401(k) plan may be the most important part of your retirement investment plan. But should it be the only part? Here are five questions to help you decide:

- ✔ **What kind of lifestyle do you want to fund in retirement?** You'll find general rules of thumb indicating you need anywhere from 70% to over 100% of your preretirement income during retirement (Source: *Money*, January 2009). How much you'll need depends on your individual circumstances. If, for example, your mortgage will be paid off and you plan to stay home and watch your grandchildren during retirement, 70% of your preretirement income may be sufficient. If, on the other hand, you plan to travel extensively, 100% may be a better number.
- ✔ **How much can you count on from Social Security?** Social Security benefits were never designed as the sole source of retirement income, but they still are a valuable source of income. Those with lower incomes will find that Social Security replaces a higher percentage of their preretirement income than those with higher incomes. For 2009, the maximum Social Security retirement benefit for a worker retiring at full retirement age is $2,323 per month, with the average benefit totaling $1,153 (Source: Social Security Administration, 2009).
- ✔ **How much does your employer contribute to your 401(k) plan?** Employer-matching contributions vary by plan, but a typical match is 50 cents for every dollar contributed, up to a maximum of 6% of your pay (Source: Center for Retirement Research, March 2009). However, due to these tough economic times, many employers are reducing or eliminating matching contributions. If your employer offers a match, make sure you take full advantage of it.
- ✔ **What are your average returns on your 401(k) investments?** You can only invest in investments offered by your 401(k) plan. But within those parameters, select investments that match the long-term nature of your investment strategy and that will help grow your retirement funds over time. This is especially important now that stock market declines have substantially reduced most 401(k) balances.
- ✔ **What other sources of income can you count on in retirement?** If you already have other retirement assets, you might not need to count as heavily on your 401(k) plan. Other potential sources of retirement income might include a defined-benefit pension plan, individual retirement accounts (IRAs), an inheritance, or other investments. ✔✔✔

The Benefits of Roths

Continued from page 1

taxable when withdrawn.

Unlike a Roth IRA, annual distributions must be taken after age 70 1/2. However, funds in the Roth 401(k) can be rolled over to a Roth IRA, which would not require distributions during the owner's lifetime. There is no provision to convert a regular 401(k) to a Roth 401(k).

If you expect your income tax bracket to be similar or higher during retirement, a Roth 401(k) will typically result in more retirement funds than a regular 401(k).

Don't Forget about the Roth IRA

One advantage of the change in the Roth conversion rules is that it effectively removes the income limitations for contributions to a Roth IRA starting in 2010. In 2009, single taxpayers with modified AGI less than $105,000 and married taxpayers filing jointly with modified AGI less than $166,000 can make contributions, regardless of their participation in a qualified retirement plan. Contributions are phased out for single taxpayers with modified AGI between $105,000 and $120,000 and for married taxpayers filing jointly with modified AGI between $166,000 and $176,000 in 2009.

Starting in 2010, individuals with income over the limit can make contributions to a nondeductible traditional IRA and then immediately convert the balance to a Roth IRA. For 2009, you can contribute to a nondeductible IRA and convert the balance in 2010. In 2009, you can contribute a maximum of $5,000 with an additional $1,000 catch-up contribution if you are age 50 or older.

Since there are no required minimum distributions during your lifetime, the Roth IRA is a particularly effective way to transfer assets to family members. You can allow the Roth IRA to continue compounding on a tax-free basis during your life, with no withdrawals. If you leave the Roth IRA to your spouse after your death, he/she can roll the balance over to his/her own IRA, so no withdrawals would be required during his/her lifetime. When your spouse dies, his/her beneficiaries would then have to take distributions over their life expectancies, but qualified distributions would be taken free of federal income taxes. By using this strategy and only taking minimum distributions when required, the balance can continue to grow on a tax-free basis for years or even decades.

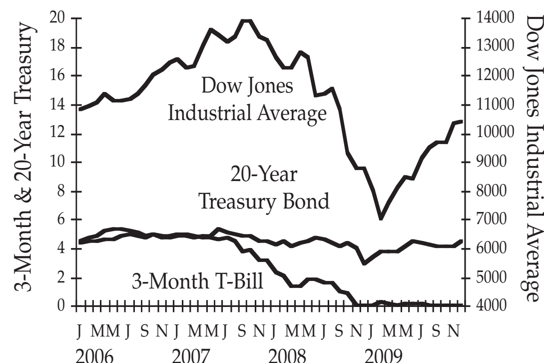
Please call to discuss Roth IRAs and 401(k)s in more detail, including how they can help address your retirement savings goals. ✔✔✔

Market Data

	Month End Dec 09	Nov 09	Oct 09	% Change 2009	2008
Dow Jones Ind.	10428.05	10344.84	9712.73	18.8%	-33.8%
S&P 500	1115.10	1095.63	1036.19	23.5	-38.5
Nasdaq Comp.	2269.15	2144.60	2045.11	43.9	-40.5
Wilshire 5000	11497.41	11192.72	10618.96	26.5	-38.7
Gold	1100.50	1175.75	1040.00	30.0	1.6
Silver	16.92	18.32	16.26	11.2	3.4
				Dec 08	Dec 07
Prime rate	3.25	3.25	3.25	3.25	7.25
Money market rate	0.05	0.07	0.07	1.84	4.49
3-month T-bill rate	0.11	0.06	0.08	0.05	3.28
20-yr. T-bond rate	4.53	4.19	4.20	3.04	4.58
Dow Jones Corp.	4.43	4.21	4.40	7.16	5.89
Bond Buyer Muni	5.40	5.44	5.25	6.02	4.88

Sources: *Barron's, Wall Street Journal* *Past performance is not a guarantee of future results.*

4-Year Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield January 2006 to December 2009



Sources: *Barron's, Wall Street Journal*

Review Your Estate Plan

> **"** More than half of retirees had nonmortgage debt when entering retirement. Of those with mortgage or other debt, 41% had liabilities that equaled or exceeded the value of their savings and investments. **"**
>
> Source: Securian Financial Group, 2009

BETWEEN THE FLUCTUATING stock market and declining home values, the value of your assets has probably changed dramatically over the past couple of years. Thus, you should probably take a look at your estate plan, considering the following:

✔ **Take another look at your plans for distributing your estate.** Your estate plan may distribute specific assets to specific heirs, such as a business to one child and investments to another child. While those assets may have been equal in value in the past, that may have changed. You may want to place provisions in your estate plan to equalize distributions.

✔ **Review amounts being placed in different trusts.** Many estate planning documents indicate that trusts should be funded with assets equal to the exemption amount or the generation-skipping transfer tax exemption amount. Lower asset values coupled with significantly larger exemption amounts could result in placing too large a percentage of your estate into trusts.

✔ **Use lower asset values to leverage your lifetime gifting strategies.** In 2009 and 2010, you can gift up to $13,000 ($26,000 if the gift is split with your spouse) to any individual free of gift taxes. This amount is adjusted annually for inflation, in $1,000 increments. You can also gift up to $1,000,000 during your lifetime without paying gift taxes. When asset values are low, you might want to gift some of those assets to your heirs. There are other strategies to leverage gifts, such as setting up trusts that discount the value of the gift and using family limited partnerships or limited liability companies.

✔ **Consider converting traditional individual retirement accounts (IRAs) to Roth IRAs.** While your adjusted gross income cannot exceed $100,000 in 2009 to convert, anyone can convert starting in 2010. Amounts rolled over from a qualified pension plan, such as a 401(k) plan, to a traditional IRA can also be converted to a Roth IRA. Transferred amounts must be included in income if they would be taxable when withdrawn (e.g., contributions and earnings in traditional IRAs and earnings in nondeductible IRAs), but are exempt from the 10% federal tax penalty. While there are many factors to consider before converting, a major factor is the ability to pay the income taxes with funds outside the IRA. With lower investment values, your tax bill should also be lower. Once the IRA is converted to a Roth IRA, qualified distributions, whether taken by you or your heirs, will be received on a tax-free basis. ✔✔✔

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Ed Stiles

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