Nicholson Financial Services

Did you know...?

Summer/Fall 2009

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As I revise this newsletter for the 4th time, I can't believe that Summer is almost over. For many kids, it is over already. My family took a big step forward yesterday as my son got on the bus for the first time to head to his first day of Kindergarten. It never ceases to amaze me how fast time seems to go by and how quickly things change. The change in the mood of investors has been dramatic since my last missive. The high level of fear that was rampant in the first quarter has been replaced by cautious optimism. Once again, I commend all my clients for your patience, perseverance and understanding. Above all, I thank you for the trust you place in me.

Nicholson Financial Services, Inc. is an independent firm.

In this issue:

Do people really think that way?

A couple of months ago, I was at a cocktail party. I was listening to some of the conversations that were going on near me. As usual, money or investments tend to be topics that come up. One conversation in particular caught my attention. I listened as one man was explaining to two other couples how he sold all of his investments, including his 401K, back in late January. He was clearly happy with his decision, as he missed what was a terrible February. He explained how he was very nervous about the markets and the economy and that he felt more comfortable being in cash. The people he was talking with nodded and agreed with his assessment. What floored me was his answer to a question posed to him. One of the women asked, "so, when do you think you would be comfortable enough to get back in?" Without hesitation he responded "I will feel better when the market (the Dow 30 in this case) is back above 10,000." Bear in mind, the market was already back to about 8,800 by this point, and he had gotten out around 8,000. I found myself thinking "ok, this guy is going to wait until the market has rebounded 50% or more (from the March 6 low) and then he is going to get back in. Brilliant. Do people actually think like this?" Yes they do! One of my main goals as a financial advisor is to guide my clients to become savvy investors. Savvy investors recognize that crisis breeds potential opportunity and that successful investing is seldom "comfortable." However, most people are not savvy investors. They let their emotions make their decisions for them instead of relying on logic. I am sure that there are many people who followed a similar course of action.

Now, think about what that means. If many investors are staying in cash until the Dow is back to 9,000 or 10,000 (many investors seem to be infatuated with round numbers), those of us who have stayed invested stand to benefit from their rise in comfort level. The equity markets are driven primarily by supply and demand. I view the increased demand from these investors who are putting their dormant assets back to work as a positive.

As I have said to many clients on the phone, "it is amazing how fast the fear of losing turns into the fear of missing out."

One of the other main concerns that many clients have brought up to me is that of unemployment. They hear in the news that unemployment has increased and they translate that into fear of the economy getting worse. Naturally, that would have a negative impact on their investments. The truth is, unemployment is a *lagging* indicator. If you look at every recession going back to 1960, you will see that unemployment peaks either at the end of the recession or *after* the recession ended. For example, the 2001 recession ended at the end of that year. However, unemployment did not peak until July 2003, a full year and a half later. More often than not, the equity markets have bottomed and started to rebound before the recession was over. In many cases going back to 1960, the markets rebounded for a year or more before unemployment peaked. In almost all cases, when it did peak, unemployment dropped quickly. I think employers overestimate and cut more jobs than they probably need to. As the economy starts to improve, they find themselves short-handed and rapidly begin hiring again. In a case like the recession of 1981-1982, unemployment skyrocketed much like it did last year. After the peak, the rate dropped just as fast as it rose. It is my opinion that we may see something similar with this recession. So, I encourage clients not to be too concerned about the unemployment statistics. (This information was gathered from a chart obtained from the National Bureau of Economic Research. It shows every recession since 1960 with an overlay of the unemployment rate. If you would like to see the chart, just ask.)

Roth IRA Conversions in 2010: Goodbye, Income Limits!

Regardless of your filing status or how much you earn, you'll be able to convert a traditional IRA to a Roth IRA starting in 2010.

With the lure of tax-free distributions, Roth IRAs have become popular retirement savings vehicles since their introduction in 1998. But if you're a high-income taxpayer, chances are you haven't been able to participate in the Roth revolution. Well, that's about to change.

What are the current rules?

For 2009, if your modified adjusted gross income (MAGI) is greater than $100,000, you can't convert a traditional IRA to a Roth IRA. This $100,000 limit applies whether you're single or married filing jointly. And if you file your taxes as married filing separately, you can't make a conversion at all--regardless of your income level.

In addition, your ability to make annual contributions to a Roth IRA depends on your MAGI:

If your federal filing status is:	Your Roth IRA contribution is reduced for 2009 if your MAGI is:	You can't contribute to a Roth IRA in 2009 if your MAGI is:
Single or head of household	$105,000 but less than $120,000	$120,000 or more
Married filing jointly or qualifying widow(er)	$166,000 but less than $176,000	$176,000 or more
Married filing separately	More than $0 but less than $10,000	$10,000 or more

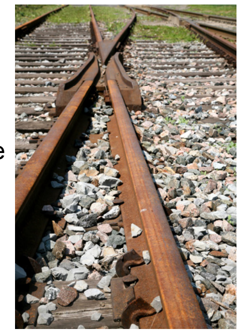
What is--and isn't--changing

In 2006, the Tax Increase Prevention and Reconciliation Act (TIPRA) became law. TIPRA repeals the $100,000 income limit for conversions, and allows conversions by taxpayers who are married filing separately, beginning in 2010. This means that regardless of your filing status or how much you earn, you'll be able to convert a traditional IRA to a Roth IRA starting in 2010.

Unfortunately, TIPRA does not repeal the income limits for annual Roth contributions. However, depending on your circumstances, beginning in 2010 you may be able to make your annual IRA contribution to a traditional IRA, and then convert that IRA to a Roth. Your financial professional can help you determine if this works for you.

Convert now, pay later

Normally, when you convert a traditional IRA to a Roth IRA, you're required to include the amount converted--minus any nondeductible contributions you've made--in your gross income in the year you make the conversion.



However, to ease the pain of a potentially large tax hit in 2010, TIPRA includes a special rule for 2010 conversions only: if you convert your traditional IRA to a Roth IRA in 2010, you can report half the income from the conversion in 2011, and the other half in 2012.

For example, assume that in 2010 your sole traditional IRA is worth $200,000, and you've made $50,000 of nondeductible contributions. If you convert the entire IRA to a Roth in 2010, $150,000 will be subject to federal income taxes. If you use the special rule, you can report half of the taxable amount ($75,000) as income in 2011, and the other half as income in 2012. Alternatively, you can report the entire $150,000 as income in 2010. (Note: state tax rules may differ.)

(Note that a SEP IRA can also be converted to a Roth IRA, and a SIMPLE IRA can be converted two years after you begin participating in your employer's SIMPLE IRA plan.)

Is a Roth conversion right for you?

The answer is complicated, and depends on many factors, including your income tax rate, the length of time you can invest the funds without withdrawals, your state's tax laws, and how you'll pay the income taxes due on the conversion.

Even if you decide to convert, whether it makes sense to use the special 2010 deferral rule depends on your individual situation. It may also depend on where you think income tax rates are headed. If you expect rates to be lower in 2010 than in 2011 and/or 2012, deferring the tax hit may not be a good idea. Your financial professional can help you run projections to determine if the special rule is appropriate in your particular case.

Estate Planning Opportunities in a Down Market

A down market can mean tough times, but it can also present unique opportunities to minimize property transfer (gift and estate) taxes. While owning assets that are losing value might seem like a bad thing, it may actually be a great time to reduce your taxable estate by gifting those assets to beneficiaries. That's because current low asset values and interest rates enable you to make gifts at a lower gift tax cost. And, if and when the market rebounds, those assets will be growing in your beneficiary's estate and not in yours. Here are a few gift-giving techniques that take advantage of today's economic climate.

***Note:** This article discusses federal tax rules only. Individual states impose their own property transfer taxes using rules that may be different from the federal rules.*

Basic gifting

Each year, you can make gifts of up to $13,000 to anyone you want, to as many people as you want, tax free under the annual gift tax exclusion. You can give away twice that amount if both you and your spouse make the gifts together (this is called gift splitting). And, you can give away an unlimited amount if you pay tuition or medical bills on behalf of another person (just be sure to make these payments directly to the school or health-care provider).

Family loans

You can lend money to your children at the current IRS minimum interest rate (known as the AFR, which changes monthly), and then potentially forgive an amount equal to the gift tax exclusion each year. (The gift tax exclusion amount is adjusted for inflation; $13,000 is the figure for 2009.)

Grantor retained annuity trust (GRAT)

A GRAT is an irrevocable trust with a specified term (e.g., 10 years) into which you gift assets that you expect will greatly increase in value in the future. You receive annuity payments during the trust term, and at the end, your beneficiaries receive any remaining property.

The transfer of assets to the GRAT is a taxable gift to the trust beneficiaries. The value of the gift for tax purposes is determined based on the current IRS rate (known as the 7520 rate, which also changes monthly).

Tax savings are achieved because the annuity payments are calculated to result in a gift tax value of zero. It's anticipated, however, that the actual interest earned will be higher than the 7520 rate, leaving a substantial value in the GRAT at the end of the term. This remaining value is passed on to your beneficiaries tax free.

Intentionally defective grantor trust (IDGT)

An IDGT is an irrevocable trust that has a purposeful flaw (i.e., you retain some control over the trust) so that you, and not the trust entity, pays the income taxes on trust income (thus, an IDGT is ideal when you want to transfer income-producing assets). Even though you retain some control over the trust, IDGT assets will generally not be included in your taxable estate at your death.

You sell assets to the IDGT in return for an installment note, with interest calculated based on the current AFR. There is no gift tax because it is a "sale" (except for an initial gift that "seeds" the trust). However, because you and the trust entity are considered the same taxpayer, no gain is recognized on the sale, and interest you receive under the note is not considered taxable income.

Tax savings are achieved because, hopefully, the value leaving your estate via the sale will exceed the value returned to your estate via the note. You also reduce your estate by paying the income taxes on IDGT income.

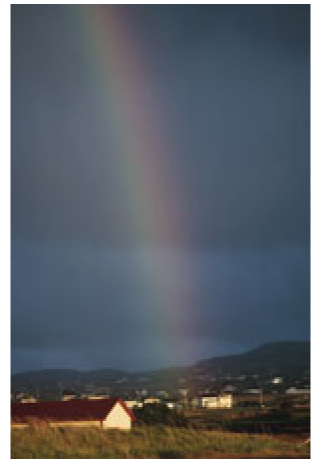
Charitable lead trust (CLT)

A CLT is an irrevocable trust with both charitable and noncharitable beneficiaries. It's called a lead trust because it is the charity that is entitled to the first or lead interest from the trust property. After the specified term, the remaining trust property passes to you or another named noncharitable beneficiary.

At the time assets are placed into the CLT, you receive a current gift tax deduction equal to the present value of the income stream that will be going to the charity. The interest rate used is based on the current 7520 rate. The lower the interest rate, the higher the deduction. As with a GRAT or IDGT, it is hoped that the CLT assets will appreciate beyond the 7520 rate, allowing the excess to pass tax free.

Conclusion

These gifting strategies, and others, can turn this economic downturn into a mixed blessing.



A down market can mean tough times, but it can also present unique opportunities to minimize property transfer (gift and estate) taxes. While owning assets that are losing value might seem like a bad thing, it may actually be a great time to reduce your taxable estate by gifting those assets to beneficiaries.

Estate planning tools that are generally less attractive when interest rates are low:

- *Qualified personal residence trust (QPRT)*
- *Charitable remainder annuity trust (CRAT)*

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Ask the Experts

Can I change investments in my 529 plan account?

The short answer is yes. During the stock market declines of 2008-2009, many 529 plan participants made investment changes in their accounts. But the rules for doing so depend on whether the change is for *future* contributions or *existing* contributions.

Future contributions. Typically, most 529 plans allow you to change your investment allocations for your future contributions at any time. Some plans let you do this online in a matter of minutes, while other plans require you to mail in a form with your new investment preferences. (Note that this seemingly inconsequential difference may be an important one if you want to act quickly.)

Existing contributions. The rules are more restrictive when it comes to changing investment allocations for your existing contributions. Generally, under federal law, 529 plans are permitted (but not required) to allow you to change the investment allocations for your existing contributions once per calendar year. But for 2009 only, 529 plans may allow you to do so twice per year. (No word yet on whether the IRS will extend this "twice-per-year" rule to 2010 and beyond, though the 529 industry is sure to lobby for it.)

If you've already made two investment changes this year but want to make another, there is a workaround: most 529 plans allow you to change your investment allocations for your existing contributions whenever you change the beneficiary of the account.

But if you don't want to change the beneficiary of your account and you're still unhappy with your investment allocations, you have one more option: you can jump ship to a different 529 plan. Under federal law, you can roll over your existing 529 plan account to a new 529 plan (college savings plan or prepaid tuition plan) once every 12 months without any federal tax penalty and without having to change the beneficiary.

I am a conservative investor. Is a 529 plan a good way to save for college?

It can be. The investment options for 529 college savings plans have broadened dramatically since their inception in 1996. And with the market turmoil of the past year, many states have expanded the conservative investment options in their 529 college savings plans as more families look to protect their college savings from financial risk.

For example, Colorado is offering a stable value fund in its 529 plan paying 3.35% interest through the end of 2009, and a few other states are offering principal-plus-interest options that guarantee a minimum rate of interest while protecting your principal. And as 529 account holders funnel more money into conservative investment options, the list of states offering such options in their 529 college savings plans is likely to grow.

You might be asking why you should bother with a 529 plan when you could earn a comparable rate of interest on your own. Well, even if you could earn a similar rate outside of a 529 plan, you would generally have to pay income taxes on the earned interest at ordinary income tax rates. By contrast, any interest and capital gains earned in a 529 plan account are completely free of federal (and typically state) income tax, provided the withdrawal is used for the beneficiary's qualified education expenses. However, any withdrawal not used for such expenses is subject to income tax and a penalty.

Note: *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.*