



# *The Financial Planning Newsletter*

**Is It a Good Environment for Roth IRA Conversions?** Today, anyone with modified adjusted gross income of less than \$100,000 a year (individual or joint income) can convert a traditional IRA account to a Roth IRA. All US taxpayers will get the same benefit in 2010 under current tax laws. That's right, starting next year conversions can be made regardless of income!

This could be an excellent idea for anyone who is (unfortunately) unemployed this year and has little or no income with the expectation that their 2009 tax rate could be very low.

Remember, when you do a conversion, you must pay income taxes on the amount being converted. The conversion amount can be all of the funds in your traditional IRA(s) or just a portion of those assets. The money to pay these taxes should come from non-IRA sources. Otherwise, the 10% penalty may apply.

Subject to certain rules, such as the 5 year holding period and age 59 ½ age for tax-free withdrawals (among others), you won't ever pay tax again on the Roth IRA monies. That's where the silver lining comes in for you or for your heirs if you pass the Roth IRA money on to them.

The conversion issue is a potentially attractive retirement and estate-planning idea for all Americans who want to make sure they maximize the assets they have for themselves and for their heirs on a tax-free basis.

For your consideration:

- Differences between a traditional IRA and a Roth IRA: Traditional IRAs allow investors to save money tax-deferred with deductible contributions (within certain income limits if either spouse is eligible for a qualified plan at work) until they're ready to begin withdrawals anytime between age 59 ½ and 70 ½. After 70 ½ the distributions are required (except in 2009, but that's another topic entirely). Further, traditional IRAs have a nasty little surprise in them called Income in Respect of a Decedent or IRD. This IRD can play havoc with estate taxes and estate planning. Roth IRAs don't allow tax-deductible contributions, but they allow tax-free withdrawal of funds with no mandatory distribution age and allow these assets to pass to heirs income tax-free as well. If you leave your savings in the Roth for at least five years and wait until you're 59 1/2 to take withdrawals, you'll never pay taxes on the gains. The sticking point is the income tax due when converting a traditional IRA to a

Roth. The taxes are on any pre-tax contributions (which is usually all of the contributions), plus any gains. Roth IRAs usually avoid IRD since the income tax was already paid!

- Time to retirement matters: If you have more than five years until you plan to withdraw your retirement funds, conversion of traditional IRA assets to a Roth IRA will make even more sense. The longer the time span where earnings can grow tax deferred, the greater the benefit of being able to withdraw those earnings without paying tax on them.
- Your tax rate at retirement is important: Many people, such as business owners, may be paying taxes now at a fairly low rate. So they might pay higher taxes at retirement. If that's the case, converting to a Roth makes a lot of sense. Additionally, with Social Security benefits being taxable at certain income levels, Roth IRAs can allow you to limit or possibly eliminate such taxes.
- One lurking surprise of a Roth conversion: We've already discussed the taxes you may have to pay taxes on contributions previously deducted, as well as taxes on the accumulated earnings. Be aware the conversion could push you into a higher tax bracket, especially if you've accumulated sizeable earnings over the years. Further, the conversion may trigger the Alternative Minimum Tax (AMT) due to those high earnings. Ouch!

**What's a Structured Settlement? Is one right for me?** Before calling J. G. Wentworth, let's take a look at what exactly is a "structured settlement" anyway. If you've received a windfall such as lottery winnings or a large amount from a legal settlement, it might sound like you're fixed for life. The reality is your financial life has changed drastically, and you need to plan for it.

A structured settlement is a way of receiving partial payments for a major amount of money you've won or received. You hear a lot of commercials on the air for getting cash from structured settlements, but it's important to understand what they are and how they should be handled if you're ever the recipient.

- Let's start with a definition. A structured settlement is structured like an annuity. It is a contract written by an insurance company providing periodic payments to a winner in a lottery, a lawsuit or some other settlement arrangement over time. Amounts can be paid out weekly, monthly or yearly.
- The benefits: Structured correctly and with the right oversight going in, a structured settlement annuity can provide a payment stream that may be tax-free over a period of time during the winner's lifetime and remaining payments may be bequeathed to survivors.



- The pitfalls: One should never accept a structured settlement agreement without vetting it against their own tax situation or estate needs. Also, it helps to have an expert who understands these agreements well enough to know whether certain fees or charges connected with the settlement are appropriate to the overall size of the award. Keep in mind the structured settlement must be purchased by the person or company that is at fault or is making the award. Otherwise, the tax-free benefits evaporate. This is why it's particularly important to have an expert watching over the selection process from the moment of award.
- The lump sum alternative: As an example, if an awardee chooses a lump sum payment over a periodic payment based on the full amount of the award, that payment will likely be handled with an insurance contract paying the lump sum, but at a much heftier chunk of the full total. The insurance company gets a big payoff for giving you a big one-time payoff. The lump-sum payoff idea may not be worth pursuing unless it's large enough to throw off substantial investment income in the future, and you should have talented investment management making sure the lump sum is invested properly. It's always a good idea to confer with tax, financial and investment experts on the best way to go with either a lump sum or a periodic payment from the moment you've been informed you won the money.
- Keep in mind that others get an advantage too: Many attorneys are also structuring their fees to be taken directly out of a court award. This allows them to postpone receiving their share of an award on a tax-deferred basis so they can build their own retirement funds. There's nothing wrong with this, but it's important to know who else in the process might benefit from any decisions.

## **Have You Thought About the Gift of Tax-Advantaged Savings for Your Grandchild's Graduation Gift?**

It's only a few short weeks until cap and gown season begins, and for grandparents hoping to do something nice for their grandkids and maybe something sensible for their estate, there are several options to explore.

- Roth IRAs: The Roth option is a good one if you want to help them start a retirement fund of their own or if you want them to inherit a Roth IRA after your death. Remember, these Roth distributions will most likely be completely free of income tax! Roth IRAs aren't a useful alternative for very young children since there has to be "earned income" to be able to make contributions. On the other hand, many high school students do have earned income through after school jobs. Either parents or guardians can open the Roth IRA account and grandparents can make gifts to match the earnings the kids put in their Roth IRA. Also, if you have a Roth IRA, you can benefit your grandchildren by naming them as your primary beneficiaries, and when they inherit it, they'll be able to make tax-free withdrawals for a



home, an education or any other purpose. Parents or grandparents may want to consider setting up and funding a Roth IRA for their children or grandchildren as soon as the children or grandchildren have any earned income from part-time or summer jobs. This will ensure the five-year requirement is met when the individual for whom the Roth IRA is established is ready to make a withdrawal.

- **529 Plans:** Another great tool for grandparents is the 529 college savings plan. Grandparents can fill out a plan enrollment form designating a grandchild as beneficiary, select the investments from the plan's options, and make future contributions either by check or by automatic contribution. It's also fine for grandparents to make their contributions directly to a 529 account already owned by the grandchild's parents. As a refresher, 529 college savings plans allow parents or guardians to open a tax-deferred college savings plan with as little as \$25 to start in some states. A 529 college savings plan is not the same thing as a 529 prepaid college tuition plan. Prepaid tuition plans are tax-deferred savings plans allowing you to save for tuition for in-state schools (though some plans allow you to transfer out a portion of those assets to out-of-state schools). It's important to note prepaid tuition plans are not an automatic guarantee a student will get accepted into any particular college. Since 2006, qualified withdrawals from 529 plans have been permanently tax-free. In some states, contributions may also be deductible on state tax returns. All 50 states plus the District of Columbia now have 529 plans college savings plans, and a majority of them provides additional incentives, such as a state-tax deduction to in-state residents who invest in their respective plan. Visit [www.SavingforCollege.com](http://www.SavingforCollege.com) or [www.FinAid.org](http://www.FinAid.org) to help educate you in how these plans work. As for grandparents or others making gifts to 529 plans, the contributions can be made as completed gifts, which means they can apply the \$13,000 per year gift tax annual exclusion or an accelerated contribution of up to \$65,000, with a special five-year, gift-spreading election. Check with your tax adviser first. Married grandparents can double these gift-tax free amounts through the split gift technique. Another great benefit is a 529 plan owned by grandparents should not affect the grandchild's eligibility to receive federal financial aid because a grandparent's assets are not reportable on the Free Application for Federal Student Aid, or FAFSA, and the tax-free withdrawals from a grandparent-owned 529 plan are not counted as student income or student resources.
- **Coverdell Education Savings Accounts:** For grandchildren heading to private school who are under the age of 18, most grandparents can contribute up to \$2,000 annually per grandchild to a Coverdale Educational Savings Account, or Coverdell ESA. Coverdell ESA earnings accumulate free of federal income taxes, and can be taken to pay for private elementary, secondary or college. Income is a factor when making ESA contributions. You can make a Coverdell contribution as long as you have modified adjusted gross income between \$95,000 and \$110,000 if you're a single taxpayer, or between \$190,000 and



\$220,000 if you're a married taxpayer and filing jointly. Yet, if you exceed either of these requirements, you can ask the parent of the adult child to open up the account and make the contribution, though you will have to give up control over the account.

- Make a direct gift of your grandchild's tuition: Under current tax law, you can make gifts of any amount to cover your grandchild's tuition. Yet, you're going to need to pay the college directly and you need to be aware that it won't dent your federal estate tax exemption (3.5 million dollars in 2009), but it will cut the overall amount of your taxable estate. You can make additional gifts per grandchild of \$13,000 to help with other college expenses, such as travel and entertainment.

**What Assisted Living Facility Costs Could be Tax Deductions?** The Internal Revenue Code provides for deducting certain qualified long-term care costs as medical expenses. Normally, the costs of nursing home care should be deductible, but the status of an Assisted Living Facility or ALF has not been as clear. For ALF residents, qualified long-term care costs are "necessary rehabilitative services, maintenance or personal care services that are (1) required by a chronically ill individual, and (2) provided pursuant to a plan of care by a licensed health care practitioner." The ALF resident must first qualify as a chronically ill individual. The resident can meet this definition if within the previous 12 months a licensed healthcare practitioner certifies the resident meets one of two descriptions according to the Internal Revenue Code:

- The resident is unable to perform at least two activities of daily living (ADLs) without substantial assistance from another individual for at least 90 days due to a loss of functional capacity. ADLs are eating, toileting, transferring, bathing, dressing, and continence, or
- The resident requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

Maintenance or personal care services provide assistance for a chronically ill individual with his or her disabilities; therefore, if an ALF resident needs help with two ADLs, then the assistance provided by the ALF qualifies as personal care services. Likewise, if the ALF protects the individual from safety and health threats due to severe cognitive impairments, then the assistance provided by the ALF qualifies as personal care services. The certification of the chronic illness requirement must be done within the preceding 12 months. The certifying licensed care practitioner can be any physician, registered professional nurse, or licensed social worker. This practitioner does not have to be an employee of the ALF, although this practitioner could be. The licensed care practitioner must personally examine the resident and provide a written opinion. The opinion should be obtained prior to admission to the ALF.



The plan of care is not defined within the Internal Revenue Code. Federal statutes require that nursing facilities have a written plan of care for each resident. Although written care plans for ALFs are not required by federal statutes, most ALFs prepare them. The plan of care must be prepared by a licensed care practitioner, and it should be prepared at or as soon after admission to the ALF as possible.

If these requirements are satisfied, then 100% of the costs of the ALF (including room and board) are deductible on the resident's 1040, Schedule A, to the extent the costs are not reimbursed by government benefits or insurance. The resident can claim an itemized deduction for unreimbursed medical expenses to the extent such expenses exceed 7.5% of adjusted gross income. These expenses include the qualified long-term care expenses, as well as insurance premiums and other eligible medical expenses.

If the resident does not meet the requirements of the Internal Revenue Code, then the resident can still deduct the percentage of the ALF costs attributed to nursing services. It's just the other expenses of room and board and personal services would not be deductible. The ALF should provide an estimate of the deductible portion of its costs, and the taxpayer can attach the statement to the Schedule A. Typically 30% to 40% of the ALF costs are for nursing services.

*"The idea does not belong to the soul; it is the soul that belongs to the idea."*

Charles Saunders Pierce (1839-1914)