new Wealth advisors

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IRAs and 401(k) Plans: Four Strategies in a Declining Market

No doubt, 2008 was one of the worst years in the history of the stock market, and one of the worst for retirement savings. Here are four things you can do now to help make the best of a bad situation.

1. Review your retirement plan

Review your overall retirement plan with your financial professional. What, if any, adjustments can you make to help you reach your retirement goals? If you were planning to retire in a certain year, determine if that's still realistic, and calculate how much longer your assets might last if you work a few years longer. Can you reach your goals by using a smaller withdrawal rat assumption, or by increasing your IRA or 401(k) savings? Does your asset allocation still make sense? And if you don't have a plan for your retirement, now is a good time to think about establishing one.

2. Convert your traditional IRA, or transfer 401(k) plan securities, to a Roth IRA

Due to declining values, the tax cost of converting to a Roth IRA has dropped dramatically for many investors. Consider whether converting to a Roth IRA makes good financial sense for you. The taxable portion of your traditional IRA will be subject to ordinary income tax in the year of conversion, but qualified distributions from your Roth IRA will be entirely free from federal taxes.

For 2009, you're able to convert only if your modified adjusted gross income is $100,000 or less (this dollar limit applies whether your tax filing status is single or married filing jointly). If you're married filing separately, you can't convert at all in 2009. But if these rules preclude you from converting, there's always next year--literally. These limitations are repealed in 2010, so anyone will be able to convert a traditional IRA to a Roth, regardless of income level or marital status.

Similarly, if you've decided a Roth IRA makes sense for you, and you're entitled to a distribution from your 401(k) plan, keep in mind that you can roll over (that is, essentially convert) your non-Roth assets to a Roth IRA (hardship withdrawals, certain periodic payments, and required minimum distributions (RMDs) can't be rolled over). This may be especially attractive if you're entitled to an in-kind distribution of employer stock whose values are seriously depressed--you'll pay tax on this reduced value and any additional appreciation may be tax free. (The same income and marital status limitations that apply to traditional IRA conversions also apply to rollovers from 401(k) plans to Roth IRAs in 2009.)

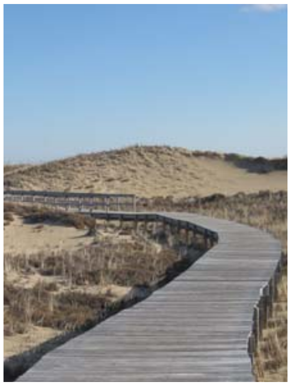

Photo by John Nelson Ferrara

3. Undo a 2008 conversion in 2009

What if you already converted your traditional IRA to a Roth in 2008, and your IRA balance has taken a significant hit since then? The tax cost of converting was probably much greater than if you had waited until 2009 to convert. Well, don't fret--you can undo a 2008 conversion up until the due date for filing your 2008 tax return, including extensions. Technically called a "recharacterization," this procedure allows you to treat the conversion as if it never occurred.

To undo your 2008 conversion, you need to carefully follow these steps:

- Inform your IRA providers (the one holding the Roth IRA and the one providing the traditional IRA, if dif-

About New Wealth Advisors.

New Wealth Advisors is an independent, fee-only, SEC-registered investment advisor, operating as a multi-family investment office. We work with newly wealthy individuals and families to protect, grow and manage assets.

ferent) that you intend to recharacterize your Roth IRA to a traditional IRA. You must provide this notice on or before the date the assets are transferred back to the traditional IRA.

- Make sure the transfer is completed by the due date for filing your federal income tax return for 2008, including extensions. For most taxpayers, that can be as late as October 15, 2009. (If you've already filed a timely 2008 tax return, you can still recharacterize by making the transfer and filing an amended return by October 15, 2009. Be sure to write: "Filed pursuant to Section 301.9100-2" on your Form 1040-X.)

- Report the recharacterization to the IRS (see Form 8606 for more information).

You can even reconvert your traditional IRA back to a Roth in 2009 (if you meet the eligibility requirements) beginning on the 31st day following the recharacterization.

4. Continue to contribute

Despite the recent downturn, for many people IRAs and employer retirement plans remain important vehicles for retirement savings. Make sure you're taking full advantage of any company matching contributions you're entitled to. And if you're age 50 or older, keep in mind that you may also be able to make catch-up contributions (up to $1,000 for IRAs and $5,500 for 401(k) plans in 2009). It's a classic good news/bad news situation. If you're holding a stock that has become worthless, the bad news is obvious: you've lost your investment. The good (or at least better) news? You may qualify to deduct the investment as a loss on your tax return.

> **Roth conversions**
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> Individuals who would like to contribute or convert to a Roth IRA in 2009 but don't qualify because of income limitations might benefit from making nondeductible contributions to a traditional IRA today, and converting the funds to a Roth IRA in 2010, when the income limits no longer apply. Additionally, for Roth conversions in 2010 only, any resulting taxable income will be deferred until 2011 and 2012 (with 50% taxed in each year).

Writing Off Worthless Securities on Your Taxes

It's a classic good news/bad news situation. If you're holding a stock that has become worthless, the bad news is obvious: you've lost your investment. The good (or at least better) news? You may qualify to deduct the investment as a loss on your tax return.

Worthless stock or bonds are those that are *completely*--the key word here being completely-- without value. A company's filing for bankruptcy does not necessarily mean that the stock is worthless; the stock may still trade and retain at least some of its value.

The mechanics

If you own stock in a company that liquidates, you may receive at the end of the year a Form 1099-DIV, which lists the liquidating distribution made during that year. For tax purposes, you should treat this distribution as if you had sold the stock, using the distribution date on the form as the date of sale. You would subtract your cost basis from the amount of the distribution.

If you don't receive a 1099--and it's highly likely you won't--you may still be able to take a deduction for worthless stock, but the process becomes more challenging. You'll need to be able to present proof that the stock became worthless during the year in which you're deducting the loss. Examples of documents that might be considered proof include a letter from the company stating that it has shut down and there are no assets to pay shareholders, or a letter from a broker stating that the stock no longer has value. For tax purposes, worthless stock is treated as though you sold the shares on the last day of the year in which they become worthless.

Abandoning a stock

You may also be able to claim a stock as worthless if you abandoned it after March 12, 2008. To do so, you must relinquish all rights to it and receive nothing in return; however, you should consult a tax professional to ensure that the transaction is not considered a sale, exchange, contribution to capital, dividend, or gift, which could change the tax implications.

Don't ignore timing

In general, you must claim a loss on a worthless stock in the year in which it becomes worthless. (However, if you do neglect to claim the loss in the appropriate year, you can do so later by filing an amended tax return within 7 years.) IRS Publication 550 includes more information about recognizing capital gains and losses.

What if a stock is worth almost nothing?

If a stock is no longer traded but is not formally defunct, there's another (though more complicated) possibility for milking tax value from an investing mistake. You could sell the shares in an arm's length transaction (to a willing, unrelated buyer for fair value). Be sure that ownership of the shares transfers to the new owner.

You also could check with your brokerage firm to see whether it purchases virtually worthless shares from customers for a nominal amount to supply them with a trade confirmation for tax purposes.

Writing off worthless securities is far more complex than this brief discussion might suggest. Consult a tax professional to ensure you don't make any missteps.

What You Don't Know Can Hurt You

You've probably heard the saying, "what you don't know can't hurt you," but when it comes to your finances, ignorance is not necessarily bliss. It's easy to make bad financial decisions when you lack sufficient information or you are misinformed. By the time you realize your mistake, it's usually too late to correct it. Here are several common mistakes that can be avoided with just a little bit of forethought.

> You could make financial decisions that turn out to be wrong because you lack sufficient information or you were misinformed altogether.

Naming the wrong insurance beneficiary

Life insurance has many benefits. Among them is the fact that death benefits are generally paid directly to the beneficiary you name in the policy without passing through probate. But what happens if the beneficiary you name is unable to accept the death benefit, because he or she is a minor, deceased, or incompetent? In these circumstances, unless you've named an alternate beneficiary, the life insurance proceeds will be subject to all of the expenses and delays associated with settling an estate through probate.

What can you do before it's too late? Review your life insurance beneficiary designations at least annually to be sure the proceeds will pass to the proper beneficiary without the involvement of probate. Also, consider adding at least one contingent or alternate beneficiary in case the primary beneficiary is unable to receive the proceeds.

Selecting the wrong pension option

If you're lucky enough to have an employer sponsored pension for your retirement, the distribution choices you make usually can't be changed, regardless of whether your circumstances change. Before making your choice, get all of your plan's options from the plan administrator and review them with a financial professional who can help you crunch the numbers. Estimate your retirement income needs, then determine what the best strategy is for you and your family.

What can you do before it's too late? If you're married you're required to take a joint and survivor option, unless your spouse waives his or her rights to your pension. If you elect the single life option, your payments will be larger, but at the expense of a future spousal benefit. If you choose the single life option, make sure you have plenty of other income or life insurance to replace the pension for your surviving spouse.

Owning assets jointly

Owning assets jointly often can be a good strategy to avoid probate or minimize estate taxes. However, this form of asset ownership also has disadvantages. The joint owner has equal rights to the jointly owned asset, meaning he or she can withdraw from a joint bank or brokerage account or sell his or her interest in the asset without your consent. In addition, adding someone's name to an asset may be considered a gift, subject to possible gift taxes. And, owning assets jointly exposes those assets to the creditors of your joint owner. Finally, with respect to long-term care planning and Medicaid qualification, adding a joint owner can negatively affect your Medicaid eligibility.

What can you do before it's too late? Consider the ramifications of joint ownership carefully before implementing this strategy. If your intent is to leave the asset to the joint owner, alternatives such as payable on death accounts, trust designations, or life estates may accomplish your goal and protect your interest in the asset at the same time.

Underinsured homes

Imagine this scenario: you just suffered through a terrible fire that destroyed your home and most of its contents. You get an estimate on the cost to rebuild your home and file a claim with your homeowners insurance carrier. To your shock, you find that they are not going to cover the entire cost to rebuild. You thought your policy covered the full replacement cost of your home. However, the policy actually provides extended replacement cost, which offers up to 120% of the policy's face amount--not enough to cover all of the costs to rebuild your home.

What can you do before it's too late? Review your policy at least annually and make sure the face amount is enough to cover the cost to rebuild your home should the unthinkable occur. That means you need to know the approximate cost to rebuild, including any additions and improvements you made to the home. Also, take into consideration increasing costs of materials and labor.

Other common mistakes

- Failing to provide for financial loss due to a non-work related disability
- Miscalculating how much life insurance you need
- Owning too much company stock in your employer sponsored retirement plan
- Underestimating how long your retirement may last
- Overestimating the annual rate of return you'll earn on your investments
- Trying to save for your children's college education at the expense of saving for your retirement

Is it possible to accidentally disinherit my heirs?

Yes. One of the most tragic estate planning mistakes is unintentionally disinheriting an heir. Here are some of the most common ways this unfortunate situation can occur.

One of the biggest causes of accidental disinheritance is the simplest: failure to make a will. In this case, property passes according to the intestacy laws of the state in which you're "domiciled."

Making an ineffective or faulty will can also result in misdirected allocations. For example, you may fail to provide for children born after you make your will (this is what happened to Anna Nicole Smith and Heath Ledger). The lesson here is to forgo the do-it-yourself kit and hire an experienced estate planning attorney to draft and execute your will, and review it every year or two.

Failing to update your will can result in allocation that are made according to an old will.

This can lead to unwanted allocations (for example, the disinheritance of children when Mom or Dad remarries and everything passes to the new spouse). Make it a rule to review and update your will periodically, especially after major life events such as marriage, a birth or adoption, divorce, or death. Also, update beneficiary designations (for life insurance policies, retirement accounts, payable on death accounts, etc.) annually. And, remember that beneficiary designations trump provisions made in your will.

A fourth cause of accidental disinheritance is what's known as ademption. This is the failure of a specific bequest made in a will because the property no longer exists in the decedent's estate for some reason. For example, you might leave your car to your son in your will, and then sell or gift it to someone else before you die. A similar situation can occur when a life insurance policy is allowed to lapse (so check that your elderly parents don't forget to make their premium payments).

How do I purposefully disinherit an heir?

While you can easily disinherit a nonheir by not mentioning him or her in your will, the rules are more complicated when it comes to your heirs. Merely not mentioning the name of a child or spouse in your will might not disinherit him or her, and doing so can even open the door for a will contest. In a will contest, the heir who is left out could argue that he or she was mistakenly overlooked. The outcome of a will contest depends in part upon your state's law regarding an omitted (referred to as "pretermitted") spouse or child.

To be sure that your intent to disinherit an heir is unequivocal, you should consider including a disinheritance clause in your will. Such a clause can discourage the disinherited heir from contesting your will. This clause would indicate the exact name of the heir you wish to disinherit, and explicitly state that the reason he or she is not included is because you wish to disinherit him or her.

Be aware that in most states, you cannot disinherit your spouse completely. If you live in a community property state, your spouse automatically owns one-half of the community property, which generally includes property that either of you acquired during your marriage. In all states, spouses are protected from disinheritance because they're allowed to claim a statutory share (also known as "electing against the will"). A statutory share can run anywhere from one-quarter to one half of an estate, regardless of the terms of your will.

Also be aware that, while you have the right to disinherit a child, that right is restricted by laws that grant certain inheritance rights to minors, and protect children of any age from accidental disinheritance.

You should consult an experienced estate planning attorney if you're considering disinheriting an heir.

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