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**Estate Planning Benefits of a Roth IRA**

*The following is a recent blog post by Jim Guarino, CPA/PFS, CFP and Partner of MFA - Moody, Famiglietti & Andronico.*

2010 certainly offers some new and interesting financial planning opportunities for high net-worth individuals. Chief among them, and something my colleagues (Jeff Arsenault, Carl Famiglietti) and I have been discussing on MFA’s Business Insights Blog, are the new Roth IRA conversion rules that effectively eliminate the income limitations associated with converting a traditional IRA to a Roth IRA. Beginning in 2010, all taxpayers — regardless of income levels — can now convert a traditional IRA to a Roth IRA.

Given the appropriate facts and circumstances, a Roth IRA conversion can be a powerful strategy for providing continued tax free growth of retirement assets, not only for investors, but for future beneficiaries of their Roth IRA as well. However, what might be a surprise to some are the additional estate planning benefits that can be derived from a Roth IRA conversion. Let’s take a look at some of the more significant benefits that are available when a Roth IRA conversion is utilized as a tool for estate planning purposes.

**1. Estate and Gift Planning**

One of the more important reasons a Roth IRA can be such a valuable estate-planning tool is it affords the opportunity to provide heirs with a lifetime of tax-free returns. Because withdrawals from a Roth IRA are tax free, investors can effectively leave money to your heirs without also leaving them an income tax bill. Now, this benefit comes with a cost – an upfront “prepayment” of the tax associated with the Roth IRA conversion — essentially, paying tax from recognition of the income on the previously deferred tax-deductible contributions and accumulated earnings. While this may seem like a fairly steep price to pay, there is a huge estate and gift tax advantage to this strategy.

When conversion tax is paid, investors effectively prepay any future income taxes heirs would owe from inheriting the IRA assets. In essence, this makes a tax-free gift (the income tax on future distributions) to heirs without having to use any current year or lifetime gift tax exemption. Just as important, for those individuals with a potentially taxable estate (see below), prepaying the Roth IRA conversion tax further reduces the size of the taxable estate. In other words, the conversion tax is being paid with assets that would (arguably) otherwise be subject to an estate tax upon death.

It is important to note what is currently going on with estate taxes. Unless new legislation is enacted, estate tax rates (as well as income tax rates) are scheduled to revert to the rates that were in effect in 2001. Therefore, the highest estate tax rate would skyrocket to 55 percent and the top marginal income tax rate would likewise increase from 35 percent to 39.6 percent. Estates would begin to pay an estate tax at the \$1 million threshold. (NOTE - there is currently no estate tax in effect for 2010, however the 2009 version of the law began taxing estates at the \$3.5 million threshold and applied a maximum tax rate of 45 percent.)



**2. No Required Minimum Distributions at Age 70-1/2**

Another estate planning benefit of Roth IRA conversions is that Roth IRAs are not subject to Required Minimum Distributions (RMD). Unlike a traditional IRA where at age 70-1/2 investors must begin taking annual distributions, a Roth IRA offers the option to leave all of the money in the IRA account and take advantage of tax-free compounding until you die. For individuals who won’t need this money in retirement, leaving it in a Roth IRA provides the option to let the money keep growing for the benefit of heirs

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without being reduced by RMD or income taxes. After the account owner's death, beneficiaries will be required to take distributions from the Roth IRA however, they will owe no income tax on these distributions.

Here is a final thought as to why one might consider utilizing this strategy; not only do you and your heirs gain an extended deferral period, but if your heirs are in a higher tax bracket than you when they begin to receive their distribution, the "family unit" as a whole will have saved income tax as part of the Roth IRA conversion strategy.

### 3. Ability to Contribute to a Roth IRA after Age 70-1/2

To further maximize the strategy discussed in point two above, investors can continue to invest in a Roth IRA after age 70-1/2 — not so with a traditional IRA. The rules specify that while a traditional IRA account can be opened after age 70-1/2, it can only be funded with rollover, or direct transfer funds. A Roth IRA, on the other hand, has no maximum age restriction as long as the individual has "earned" income to fund the Roth IRA. In essence, what this means is that the Roth IRA continues to be a retirement plan vehicle for individuals that may decide to continue working past age 70-1/2. This allows individuals to transfer additional estate assets (comprised of Roth IRA retirement accounts) in a more income tax efficient manner to their heirs.

The Roth IRA conversion opportunity must be carefully analyzed in order to decide if it makes sense, but for many high net-worth individuals, the estate planning benefits alone may make the difference in deciding whether or not to convert. Those interested in pursuing this strategy should be sure to consult with a seasoned financial planner for guidance.

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## What You Should Know about Inherited IRAs

The rules governing inherited IRAs can be complicated. Here are the major issues.

### Transferring inherited IRA assets

If you inherit an IRA from someone who isn't your spouse, your options are fairly limited. You can't roll the proceeds over to your own IRA, treat the IRA as your own, or make any additional contributions to the IRA. What you can do is transfer the assets to a different IRA provider, as long as the registration of the account continues to reflect that the IRA is an inherited IRA and not your own.

If you inherit an IRA from your spouse, you have many more options. You can roll all or part of the IRA proceeds over to your own IRA. You become the owner of the IRA assets, and the rules that apply to IRA owners, not beneficiaries, apply from that point on. If you're the sole beneficiary of the IRA, you can also generally treat the inherited IRA as your own by retitling the IRA in your name. But you aren't required to assume ownership of an inherited IRA. You can instead continue to maintain the inherited IRA as a beneficiary. You might want to do this if you inherit a traditional IRA and you'll need to use the funds before you turn 59½ since distributions from inherited IRAs aren't subject to the 10% penalty that typically applies to early distributions from IRAs you own.

### Required minimum distributions (RMDs)

*Nonspouse beneficiary:* Federal law requires that you begin taking distributions, called required minimum distributions, or RMDs, from the inherited IRA after the IRA owner dies. If the IRA owner died after turning 70½ and didn't take a required distribution for the year of death, you'll need to make sure to take that distribution by December 31 of the year of death in order to avoid a 50% penalty.

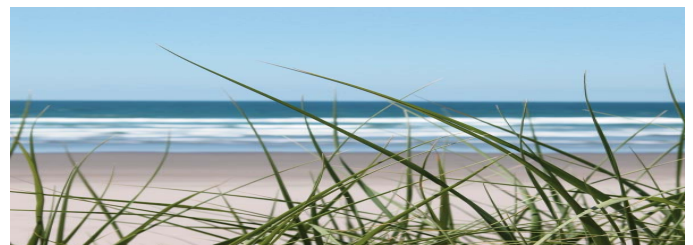
*Spouse beneficiary:* If you roll the inherited IRA over to your own IRA, or treat it as your own, then the RMD rules apply to you the same way they apply to any IRA owner—you'll generally need to begin taking RMDs from a traditional IRA after you turn 70½; no lifetime RMDs are required at all from a Roth IRA. If you don't roll the IRA assets over or treat the IRA as your own, then the same rules described above for nonspouse beneficiaries generally apply to you, except that you can defer receiving distributions until your spouse would have turned 70½.

### Special rules - inherited Roth IRAs

Qualified distributions to a beneficiary from an inherited Roth IRA are free from federal income taxes. To be qualified, the distribution must be made after a five-year holding period. The five-year period begins on January 1 of the year the deceased IRA owner first established any Roth IRA, and ends after five full calendar years. If you take a distribution from an inherited Roth IRA before this five-year period ends, any earnings you receive will be subject to federal income taxes (earnings generally come out last). If you're a spouse beneficiary, and you roll the inherited Roth IRA over to your own Roth IRA or treat the inherited IRA as your own, then you'll be eligible to take tax-free distributions only after you reach age 59½, become disabled, or have qualifying first-time homebuyer expenses. You'll also need to satisfy the five-year holding period, but a special rule applies—the five-year period for *all of your Roth IRAs* will be deemed to have started on January 1 of the year you or your spouse first established any Roth IRA, whichever is earlier.

### And speak to a financial professional if...

- You're sharing the inherited IRA with other beneficiaries. This can impact when and how you must begin receiving RMDs from the IRA.
- You don't want or need the IRA funds. You may be able to disclaim the IRA and have it pass to another beneficiary. This must be done in accordance with strict IRA rules.
- Any estate taxes were paid that are attributable to the inherited IRA. You may be entitled to an income tax deduction equal to the estate taxes paid.



## Stock Dividends: An Income Alternative

Since 2003, when the top federal income tax rate on qualified dividends was reduced, dividends have acquired renewed respect. When (or if) that tax rate increases, the long-term demand for high-quality, reliable dividends will likely increase as baby boomers approach retirement and focus on income-producing investments. Under current law, dividends will once again be taxed as ordinary income in 2011.

### Why consider dividends?

Because they can add to a stock's total return, dividends can be especially important if the market produces relatively low or mediocre returns. According to Standard and Poor's, dividend income has represented roughly one-third of the total return on the S&P 500 since 1926, though that percentage has declined over the last decade. Dividends also may mitigate the impact of a volatile market by at least partly offsetting price fluctuations to even out a portfolio's overall return.

Many experts also look at dividends as a relatively reliable indicator of a company's financial health. Investors have become more conscious in recent years of the value of dependable data as a basis for investment decisions, and dividend payments aren't easily restated. Because dividends are one sign of a company's financial health, boards of directors generally are reluctant to send investors a negative message by cutting dividends.

Also, many dividend-paying stocks represent large established companies that may have significant resources to weather economic hard times, which could be helpful if you're relying on those dividends to help pay living expenses.

Finally, dividends become even more valuable if they're reinvested rather than used to supply income. A dividend that's used to purchase more of the company's stock means you'll receive a proportionally greater share of the company's earnings the next time dividends are paid, which in turn means a larger dividend payment to be reinvested. This is assuming the company continues to do well and the dividend rate remains the same.

### Look before you leap

Investing in dividend-paying stocks isn't as simple as just picking the highest yield. If you're investing for income, consider whether the company's cash flow can sustain its dividend. Dividends on common stock are paid at the discretion of the company's board of directors, and there's no guarantee they won't be cut.

Also, some companies choose to use corporate profits to buy back company shares. That may increase the value of existing shares, but it sometimes takes the place of instituting or raising dividends.

If you're interested in a dividend-focused investing style, look for terms such as "equity income," "dividend income," or "growth and income." Also, some exchange-traded funds (ETFs) track an index that's comprised of dividend-paying stocks, or that's based on dividend yield. Be sure to check the prospectus for information about expenses, fees, and potential risks, and consider them carefully before you invest.

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### All dividends are not alike

Some dividends, such as those paid by real estate investment trusts (REITs) and master limited partnerships, don't qualify for the same maximum federal income tax rate as qualified dividends, and a portion may be taxed as ordinary income. Also, the 15% maximum rate is scheduled to expire at the end of 2010, and there is no guarantee dividends will continue to receive favorable tax treatment.

The 15% rate applies to qualified dividends, that is those paid by a U.S. or qualified foreign corporation. Also, you must have held the stock for more than 60 days during a 121-day period (60 days before and 61 days after the stock's ex-dividend date). Form 1099-DIV, which reports your annual dividend and interest income for tax accounting purposes, will indicate whether a dividend is qualified or not.

Be aware that some so-called dividends actually are considered interest for tax purposes. These include dividends from deposits or share accounts at cooperative banks, credit unions, federal savings and loan associations, and mutual savings banks.

## ASK THE EXPERTS

### How have stocks performed after a recession?

Mark Twain said it best: "History doesn't repeat itself; at best it sometimes rhymes." Past performance is no guarantee of future results, and history can be an uncertain guide in terms of what might happen with stocks this time around as the economy begins to stagger out of a recession.

That said, it's fascinating to look at how various subsegments of the stock market have behaved relative to one another. Particularly

interesting is the comparison between the performance of small-cap stocks and that of large caps after each of the last six recessions. In each case, small caps led the way out of those downturns. During the 12 months after the recession came to an end, as declared by the National Bureau of Economic Research (NBER), small caps beat large caps every time.

The average difference over the six recovery periods was 14.5%. In some cases, the difference was dramatic; in others, small caps were barely ahead. Here are the percentages by which small caps beat the S&P 500\*:



## ASK THE EXPERTS (CONTINUED)

- December 1970-November 1971: 1.3%
- April 1975-March 1976: 23.2%
- August 1980-July 1981: 28.4%
- December 1982-November 1983: 14.4%
- April 1991-March 1992: 14.8%
- December 2002-November 2003: 5.2%

Will history rhyme this time? It's hard to say. Many economists feel the current recession ended sometime in summer 2009. Small-cap stocks have certainly done well since then, but some experts feel large caps are best equipped to navigate a credit crisis. However, until the NBER retroactively declares an official end to this recession, there's no way to know for sure. And don't forget that small caps historically have involved greater risk from market fluctuation, so a double-dip downturn could hit them hardest.

\*Percentages calculated based on data from Ibbotson SBBI *Market Results for Stocks, Bonds, Bills, and Inflation* for small company stocks and the S&P 500 Composite Index.



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## How long does it take a bear market to end?

A bear market, typically defined as an overall stock market decline of at least 20% over an extended period, historically has lasted an average of a little over a year.\* On average, bull markets tend to last almost twice as long as bear markets, but sometimes the differences can be even more dramatic. For example, the bear market that began in January of 2002 lasted almost nine months; it was followed by a five-year bull market from October 2002 to October 2007.

The shortest bear market on record lasted only about six weeks, from mid-July 1998 to the end of August. The longest? October 1939 through April 1942 (almost 30 months), beating out April 1930 to June 1932 (just over two years).

However, defining bear markets and subsequent recoveries from them isn't as straightforward as it might seem. For one thing, a long-term bear market can be interrupted by one or more shorter-term bull markets or vice versa. For example, was the period between March 2000 and October 2002 a single 30-month bear market with a roughly 3-month "bear market rally" from September 2001 to the beginning of 2002, as some market technicians argue? Or was it two independent bear markets--one from March 2000 to September 2001 and a second from January 2002 to October 2002--that were separated by the shortest bull market since the Depression summer of 1932?

By definition, you only know you're in either a bear or bull market in retrospect, once the market has moved consistently in one direction or another. And the past isn't necessarily a good predictor of what will happen in the future. Since investing is about the future rather than the past, it may make sense to focus more on factors such as asset allocation than on the timing of a recovery you can't control.

\*All time frames based on data from the *Stock Trader's Almanac* 2010 on the Standard & Poor's 500, a market-cap weighted index composed of the common stocks of 500 leading companies in leading industries of the U.S. economy.

For more information or to discuss the content of this newsletter, please contact:

**Jeffrey R. Arsenault, CPA/PFS, MST, CFP®, RLP®**  
**Partner and Senior Wealth Advisor**  
**(978) 557-5395**  
**[jarsenault@newwealthadvisors.net](mailto:jarsenault@newwealthadvisors.net)**

**New Wealth Advisors, LLC**  
1 Highwood Office Park  
Tewksbury, MA 01876  
**[www.newwealthadvisors.net](http://www.newwealthadvisors.net)**

