Retire On Time™

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Retire On Time
Parker Financial Srvs, LLC
David E. Parker, CPA, CFP®
University 403b
3830 Packard Road
Suite 260
Ann Arbor, MI 48108-2051
734-975-8711
fax: 734-418-2106
dave@retireontime.net
http://www.retireontime.net

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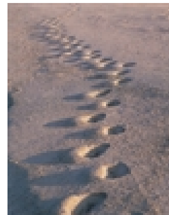
What You Should Know about Inherited IRAs



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 (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.

Student Loan Repayment Options

At one time, there was only one student loan repayment option--the standard 10-year plan. Now, there are an assortment of flexible repayment options to help borrowers meet their loan obligations. And it couldn't have come at a better time. According to an analysis of the government's National Postsecondary Student Aid Study by financial aid expert Mark Kantrowitz, the average federal student loan debt load was $23,186 last year--a figure that doesn't include private student loan debt, which has exploded in recent years along with the cost of college.

Standard plan

Under a standard repayment plan, you pay a certain amount each month over a 10-year term. If your interest rate is fixed, you'll pay a fixed amount each month; if your interest rate is variable, your monthly payment will change from year to year (but will be the same each month for the 12 months that a certain interest rate is in effect).

Graduated plan

Under a graduated repayment plan, payments start out low in the early years of the loan (presumably when a new college graduate has the lowest earning potential), then increase in the later years of the loan. With some graduated repayment plans, the initial lower payment includes both principal and interest, while under other plans, the initial lower payment includes interest only.

Example: *Assume you have a $20,000 student loan at a fixed 6.8% interest rate. Under a standard 10-year repayment plan, your monthly payment would be $230, and your total payment over the term of the loan would be $27,619, of which $7,619 is interest payments. Under a graduated 10-year repayment plan, if you chose a 4-year interest-only option, your monthly payment would be $113 for the first 4 years, then $339 for the remaining 6 years, for a total payment over the term of the loan of $29,852, of which $9,852 is interest payments.*

Extended plan

Under an extended repayment plan, you extend the time you have to pay the loan, typically anywhere from 15 to 30 years. Your monthly payment is lower than it would be under a standard plan, but you'll pay more interest over the life of the loan because the repayment period is longer.

Example: *Assume the same facts as before--a $20,000 loan at a fixed 6.8% interest rate. Under an extended repayment plan, if the term were increased to 20 years, your monthly payment would be $153 (lower than the $230 monthly payment under the standard 10-year plan), but your total payment over the term of the loan would be $36,640--$9,021 more interest than under the standard plan.*

Income contingent plan

An income contingent repayment plan is for federal student loans (including graduate Direct PLUS Loans) made under the government's William D. Ford Direct Loan program only. Monthly payments are based on the student's income, family size, and amount of loans. After 25 years of repayment (not counting time spent in deferment or forbearance), any remaining balance on the loans will be discharged (you may have to pay taxes on the amount discharged, however). A public service loan forgiveness component will discharge any remaining debt after 10 years of full-time employment in public service. Borrowers with federal student loans obtained via private lenders under the Federal Family Education Loan program can ask their lenders about an income sensitive repayment option.

Income based repayment plan

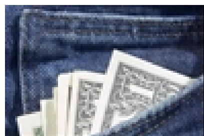
The federal government's new Income Based Repayment (IBR) program went into effect July 1, 2009. Monthly payments are based on the student's income and family size. Borrowers pay 15% of their discretionary income to student loan payments, with any remaining debt forgiven after 25 years. According to Lauren Asher, President of the Project on Student Debt and the Institute for College Access and Success, a student will generally qualify if he or she owes about as much in federal student loans as the student's current annual salary.

This program is open to graduates with a Stafford Loan, graduate PLUS Loan, or consolidation student loan made under either the Direct Loan program or the Federal Family Education Loan Program. The loans can be for undergraduate, graduate, or professional studies, as well as for job training. The Department of Education has an IBR calculator on its website at http://studentaid.ed.gov.

And thanks to recent legislation, borrowers who take out a federal student loan after July 1, 2014, will pay just 10% of their discretionary income to student loan payments, with any remaining debt forgiven after 20 years.

Praise for IBR

According to Lauren Asher, President of the Project on Student Debt and the Institute for College Access and Success,"[income based repayment] was supported by a broad coalition of student, parent, loan industry, and higher education groups to make college more affordable and accessible," and the President's budget proposal is "a way to make the program even more helpful to responsible borrowers."



Rolling GRATs Are Rockin'

A grantor retained annuity trust (GRAT) is an irrevocable trust into which you make a one-time transfer of property and from which you receive a fixed amount annually for a specified number of years (the annuity period). At the end of the annuity period, the payments to you stop, and any property remaining in the trust passes to the persons you've named in the trust document as the remainder beneficiaries (e.g., your children) or the property can remain in trust for their benefit.

A GRAT is generally used to transfer rapidly appreciating (or high income-producing) property to heirs with the main goal of transferring, free from federal gift tax, a portion of any appreciation in (or income earned by) the trust property during the annuity period.

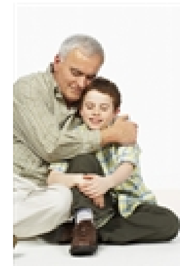
Because a GRAT is an irrevocable trust, when you transfer property to the GRAT, you're making a taxable gift to the remainder beneficiaries. The value of the gift is discounted because of your retained interest. The amount of the discount is calculated using IRS valuation tables that assume the property in the trust will realize a certain rate of return during the annuity period. This assumed rate of return is known as the Section 7520 rate, discount rate, or hurdle rate. If the property in the trust grows more than the IRS assumed rate of return, any excess growth will pass to the remainder beneficiaries gift tax free.

The catch to this strategy is that you must outlive the annuity period. If you die before the annuity period expires, the value of the property in the trust on the date of your death will be included in your estate for estate tax purposes. This, however, merely puts you in the same position you would have been in had you not used the GRAT (except for the costs to create and maintain the trust).

GRATs are typically created with a long term (5, 10, or 20 years), especially when the Section 7520 rate is low. The longer the term, the more growth that can potentially be removed from an estate. However, the longer the term, the greater the risk that you'll die during the trust term and that all of the GRAT assets will end up back in your estate.

What is a rolling GRAT?

A spinoff of the GRAT is a strategy known as a "rolling GRAT." A rolling GRAT is actually a series of GRATs with short terms (i.e., 2 to 5 years). For example, say you establish an initial GRAT (GRAT 1) for a term of 2 years. At the end of Year 1, you receive your first annuity payment, and with that payment you fund a second GRAT. When GRAT 1 terminates at the end of Year 2, you take your second annuity payment and fund a third GRAT. Any assets remaining in GRAT 1 are excess returns that are distributed to the beneficiaries. Depending on how the GRAT is initially funded, excess returns on GRAT assets may consist of interest, dividends, and any market increase (appreciation) in the value of the assets. The creation of subsequent GRATs can go on for as long as you want.



The benefits of rolling GRATs

The main purpose of the rolling GRAT is to maximize return and minimize risk.

One benefit is that if one GRAT loses money or the growth of trust assets fails to surpass the Section 7520 rate, you can start over with another GRAT. Rolling GRATs are typically funded with specific stocks or asset classes. This segregation of assets can be an investment hedge, for example, to help prevent losses, if any, on one stock from offsetting gains on other stocks.

Additionally, you can reduce the risk of having all of the GRAT assets included in your estate because of an early death. If, for example, you die 5 years into an arrangement as described above, any excess returns from 3 of the GRATs would have been removed from your estate.

"A rolling GRAT is actually a series of GRATs with short terms (i.e., 2 to 5 years)."

Further, assets from the rolling GRAT strategy are distributed to the beneficiaries earlier than with a long-term GRAT. With a 10-year GRAT, for example, assets are distributed only at the end of the 10-year period. With a series of 2-year rolling GRATs, some assets start to become available to the beneficiaries after the second year.

Finally, you can stop creating the GRATs whenever you want to. For instance, you may feel that you have gifted enough already or that you need to focus instead on rebuilding your wealth due to poor market performance.

The drawbacks

The use of rolling GRATs assumes that you do not need the annuity payments for other purposes.

Additionally, there is a risk that the Section 7520 rate may increase and keep increasing after the first year. Whereas a long-term GRAT can lock in a low initial Section 7520 rate for the entire GRAT term, rolling GRATs may be subject to fluctuating Section 7520 rates.

You'll need an attorney to draft the GRAT documents.

Retire On Time
David E. Parker, CPA, CFP®
3830 Packard Road
Suite 260
Ann Arbor, MI 48108-2051

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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*:

- 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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