Wealth Management
For Your Future

Trust & Investments

www.citystatebank.com

Fourth Quarter 2009

Pre-Retirees, Retirees Switch To Roth IRA

Converting a regular IRA to a Roth IRA brings a host of benefits. Unlike a traditional IRA, which requires you to begin withdrawing money from the account after you turn 70½, a Roth has no mandatory distributions. If you don't need the money, you can leave it to compound for the rest of your days. Even better, if you're at least 59½, any money you do take out—assuming it has been in the account five years or more—is tax-free. In contrast, withdrawals from a regular IRA are taxed as regular income.

If you are in your 60s and have a low income and big tax deductions, a Roth conversion can be almost painless.

So why doesn't everyone convert to a Roth? One reason is the current $100,000 income limit for conversions. The other problem is taxes; to convert to a Roth, you must first take money out of your traditional IRA, and that means paying income tax. However, if you are in your 60s and have a low income and big tax deductions, a Roth conversion can be almost painless. You can make the switch without creating a huge tax bill, avoid paying taxes on much of your retirement income, and provide tax-free income for your heirs as well.

To see how this would work, consider Frank and Sylvia, a fairly typical couple on the verge of retirement. He is 61 and a hospital administrator; she's a 55-year-old homemaker. They have managed to sock away $600,000 in Frank's pension plan and $400,000 in regular IRAs. They have another $600,000 invested in tax-free municipal bonds.

Frank wants to retire this year, and it turns out that he and Sylvia are in an ideal situation to convert some of their IRA assets to a Roth. Not only are they far under the $100,000 income threshold, but also, like many people their age, they can control how much income they receive in a particular year. For instance, Frank can choose to delay receiving Social Security until age 65, and also can defer payments from his pension. Keeping your income down when you're converting to a Roth IRA means that the money you pull out of the regular IRA will be taxed at a low rate or may not be taxed at all.

Apart from interest and dividends flowing from a savings account and investments in a few mutual funds, almost all the income Frank and Sylvia will receive after he leaves his job will be from their tax-free municipal bonds. They will have less than $10,000 of taxable income, and once their exemptions are figured in, that figure will drop to almost zero.

Meanwhile, the mortgage interest and property taxes Frank and Sylvia pay on their primary residence and vacation

(Continued on page 4)

Time To Rebalance And Make Year End Contributions

Investing, like walking a tightrope, is an activity that requires good balance to overcome the risks involved. Your original asset allocation was set up to match your needs and risk tolerance with your long-term goal in mind. As the market has rebounded nearly 50% since the bottom, this could prove to be a good time to rebalance your portfolio. We are nearing the end of another year, and now is the time to make your IRA or 401(k) contributions to ensure you take full advantage of all your tax deductions. Please contact us if we can help you meet your financial goals or rebalance your portfolios. Thank you for the continued trust and business.

David Albrecht, JD, CPA
VP Trust Mgr, CFO
515-981-4234
dalbrecht@citystatebank.com

Chad Stevens, CFP®
VP Investment Mgr
515-981-1400
cstevens@citystatebank.com

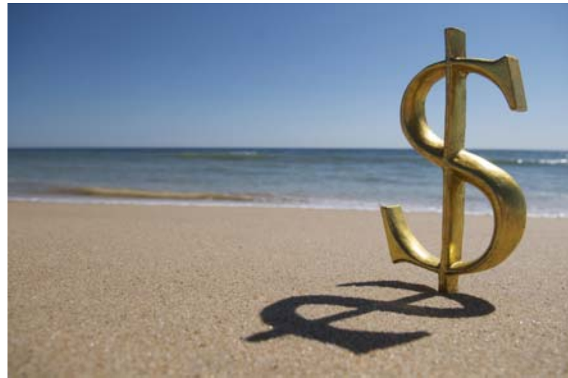
Wade Lawrence
Trust & Investments Officer
515-986-2265
wlawrence@citystatebank.com

Marital Trusts: The Devil Is In The Details

The marital trust is a powerful estate planning tool that can maximize estate tax benefits and allow you to control what happens after your death. But mistakes in execution, particularly involving funding, could undercut its usefulness.

Though the federal estate law has been in flux during recent years, there has been one constant—that one spouse can receive an unlimited amount from the other without gift or estate tax liability. (Note: The marital deduction is generally disallowed for non-citizen spouses.) The basic idea of a marital trust is to fund it with those inherited spousal assets. All trust income goes to the surviving spouse, who may also be able to use some of the assets—living in the family home, for example, or tapping trust principal to pay for long-term care.

One common alternative to the marital trust is known as a credit shelter trust (or bypass trust). By any of these names, a credit shelter trust is designed to make sure each spouse's personal exemption for federal estate tax—$3.5 million in 2009—is fully utilized in reducing the overall taxes for a couple's estate. Suppose you and your spouse together have assets worth $7 million. You could set up the trust so that when either of you dies, that person's exemption is used to fund the trust with $3.5 million. That tax-free transfer reduces the value of the estate to $3.5 million, and the trust income can be paid to the surviving spouse. Then, at the second spouse's death, the trust assets are directed to your children or other heirs without estate tax liability. The remaining $3.5 million (under current law) outside the trust can also be passed along to beneficiaries without federal estate taxes using the second spouse's exemption.



For this scenario to play out exactly that way, however, you would both have to die in 2009, as estate tax laws are in flux. The federal estate tax is scheduled to be repealed in 2010, only to be revived in 2011 under revised rules, including an exemption of just $1 million. It's probable there will be legislation to prevent the repeal of the estate tax in 2010, as the government is in need of revenue fund its operating deficit. Until a permanent solution for the estate tax is created, estate plans must be crafted carefully and revisited annually to avoid unintended consequences.

Funding a credit shelter trust can also be tricky. Normally, it's funded through a pecuniary or fractional bequest. A pecuniary bequest sends a fixed dollar amount to the trust, while a fractional bequest delivers a percentage share of the assets. Problems may occur if the language of the will leads to underfunding and unexpected estate tax for the heirs. Since there can also be errors in how individually or jointly owned property is used, it is very important to consider with which assets to fund the trust.

With all of the potential snafus, it's essential that everything is handled properly. We can work with you and your attorney to create a trust that meets your objectives. ●

Not Having A Plan Is A Costly Mistake

Your deadlines at work are impossibly tight. Your to-do list gets longer every time you turn around. And with constantly shuttling the kids to Little League and piano lessons, it's no wonder your financial life gets short shrift. Yet, however good your excuse, failing to plan your financial future is a costly mistake.

Most Americans lack a formal financial plan, according to a recent survey by the Certified Financial Planner Board of Standards. Yet the same survey finds those with a written financial plan are more satisfied with how their finances are managed, more confident about their financial decisions, and less worried about being financially secure at retirement.

Financial planning doesn't start with deciding where to invest your money, and those who arrive at the door of a financial planner asking "Where should I invest?" are likely to be greeted with two words: "Slow down." You need to step back, assess your current financial situation, identify short- and long-term goals and your risk tolerance, and figure out your timetable—what will you need, and when will you need it?

You also need to consider asset protection—though again, don't rush to buy insurance until your financial plan is in place. It can help you decide what coverage you really need, and which options and riders make sense. Beyond pointing to the obvious homeowners and automobile coverage, your plan will guide you to the right life, health, umbrella liability, and disability policies and look at any unique liabilities associated with your work or your participation in community activities or corporate boards.

A Little Bond Logic Yields Insights

In recent months the Federal Reserve has been cutting down interest rates to near zero in an attempt to help jump-start the economy. But what goes down must come up, so you can expect this trend will eventually be reversed and interest rates will begin to climb again.

If you're wondering how these developments affect bonds you already own, it's a good question. Even experienced investors can find it a challenge to grasp how bond markets really work. However, there is logic behind the ups and downs.

Bond Basics. Put simply, a bond is an IOU. Governments and businesses issue bonds to raise cash for various purposes. The markets use several descriptors to identify a bond: the issuer's name, the bond's face (or par) value, the rate of interest paid to the bondholder, and the maturity date (on which the issuer repays the principal). Because bonds trade on the open market, their prices fluctuate—and that is where things can get complicated.

How Interest Rates Affect Bond Prices. While many factors may push the price of a bond above or below its face value, perhaps the most direct impact comes from changes in interest rates. As interest rates rise—or threaten to rise—bond prices tend to fall, and vice versa.

Imagine you own a bond that pays 5% interest. After a Federal Reserve rate hike, newly-issued bonds offer a 6% rate. To someone in the market for bonds, the new rate seems much better. Lower demand for the 5% bond translates into lower prices. Conversely, if the prevailing rate falls to 4%, your bond suddenly becomes more attractive, and should command a higher price. (Note, these figures are hypothetical.)

Price vs. Yield. However, markets generally refer to bond values not by price, but by yield—the annual interest divided by the current price. If your 5% bond has a face value of $10,000, you receive $500 a year in interest. If the bond sells "at par"—the face value—the yield would be 5% ($500 divided by $10,000). But if the bond's price dips to $8,000, the yield would be 6.25% ($500 divided by $8,000).

Therefore, as price falls, yield rises, and vice versa. Think of it this way: if you buy a $10,000 bond at $8,000, your investment will "yield" more, in the form of interest payments that, in percentage terms, reflect a better return on your investment. (That's known as current yield. Another measure, yield to maturity, gauges the total return you would receive by holding the bond to maturity.)

So, once again:

- As interest rates rise—or threaten to rise—bond prices tend to fall, and vice versa.
- As prices fall, yields rise, and vice versa.

That means:

- As interest rates rise—or threaten to rise—bond yields tend to rise, and vice versa.

These movements bring the yields of existing bonds into line with those of new issues.

Exploring the Yield Curve. To understand this concept, start with the fact that long-term bonds tend to have higher yields than short- or intermediate-term bonds. That's because long-term bonds carry more risk—more can happen to affect the price during the longer term of the bond—and investors expect a higher yield for that extra risk.

The yield curve plots the current yields of bonds of various maturities on a graph. A normal curve shows a rise in yields as terms get longer. With a steep curve, long-term yields are substantially higher than short-term yields, while a flat curve shows short- and long-term yields that are more or less equal. An inverted curve happens when short-term yields are higher than long-term yields.

The yield curve is important because it may reflect investor sentiment or expectations. For instance, a steep curve indicates investors are bidding up the price (and therefore driving down the yield) of short-term rates. That could mean they expect interest rates to rise. They want to hold short-term bonds that will mature quickly, so they can reinvest at a higher rate.

What About Inflation? Why does the bond market often fall on good economic news? The fear is that strong economic growth could trigger inflation—which means bond investors would be repaid (both principal and interest) in cheaper dollars. Positive economic news can also lead investors toward stocks and away from bonds, which are often considered "safer" investments to turn to when times are tough.

In reality, of course, all markets are far more complex than this, and unusual market movements can confound even the most sophisticated analysts. Still, a little logic can make *"Inflation fears send bond yields higher"* a little easier to understand. ●

By presenting a broad view, your financial plan helps you understand how each financial decision affects other areas of your finances. For example, suppose you receive an inheritance and use it to pay off your mortgage. That frees up more of your earnings to put into your retirement plan. But your taxes rise because you've lost your mortgage interest deduction, and your expanding net worth means estate taxes could become a problem. Like a compass, your financial plan keeps you pointed in the right direction even as your life inevitably changes. What's more, the comprehensive nature of financial planning should help you avoid major mistakes—from choosing a high-flying mutual fund with no regard for its risk to overestimating how much you can safely withdraw from your nest egg.

Developing a plan takes time, but often, simply articulating your values, hopes, and dreams can increase your motivation to save. Your plan also enables you to chart your progress. Review and regularly revise it as needed, and it will be a road map that can last a lifetime.

The sooner you get on the planning road, the better. As Yogi Berra once said, "If you don't know where you are going, chances are you will end up somewhere else." ●

College Savings Help Admission Chances

If you need a little extra motivation to set aside college savings each month, consider this: With a volatile stock market taking a bite out of college endowments, financial aid budgets are shrinking and assistance will be harder to come by. Worse, many colleges are choosing not to admit students who need aid.

Today, relatively few schools have the financial wherewithal to disregard a student's ability to pay when making admissions decisions. According to Donald E. Heller, an associate professor and senior research associate at Pennsylvania State University, only about three dozen colleges and universities now commit themselves to meet every admitted student's need. "So it's safe to conclude that all other institutions, to one extent or another, take financial need into account when deciding which students to admit," says Heller.

Will your children be affected? It depends on the strength of their credentials, Heller says. Most top candidates will be accepted regardless of need, and may even be awarded merit scholarships. But other students may be judged in part on the basis of how much they will cost the school. "When admissions staffs get down to those last pools of applicants, very often they will not admit students who need financial aid if they know the school can't meet that need," says Heller. "At that point, candidates who can pay their own way have an advantage."

That's not the way things generally worked during the 1970s and early 1980s, when most colleges at least aspired to need-blind admissions policies. By the mid-'80s, however, most admissions offices had adopted a more pragmatic business model often referred to as enrollment management. The bottom line for the admissions staff was simple: Fill the class but don't exceed the financial aid budget.

Today, enrollment management is firmly entrenched at most schools. Moreover, with economics affecting alumni giving and pressure being put on endowment earnings, a student's financial situation plays an increasingly critical role in the admissions process. As a result, strategies for maximizing a student's apparent need by putting assets in parents' names and taking advantage of aid formulas that require students to spend a larger proportion of their own savings could have undesirable consequences. And not saving for college at all, while counting on financial aid to bear the brunt of school costs, could prevent your children from getting into the colleges of their choice.

The safest approach to college funding is to plan to pay as much as possible yourself. Positioning your assets to qualify for financial aid or counting on the availability of loans could backfire with the admissions office and your kids. ●

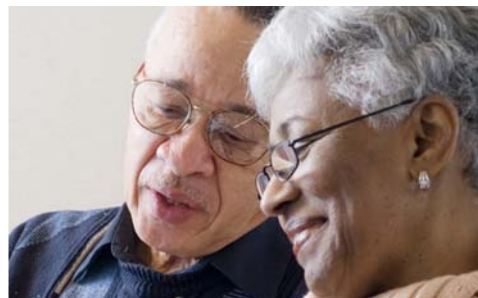
Switch To Roth IRA

(Continued from page 1)

home provide a $40,000 annual deduction for the next several years. The perfect use for that deduction, which would otherwise go to waste, is to offset $40,000 a year in income from IRA withdrawals which can then go into a Roth IRA. If they do this for four years, until Frank reaches 65 and must start receiving income from Social Security and his pension, they'll salt away $160,000 in the Roth IRA.

To give them the $85,000 a year they need to live on in the meantime, Frank and Sylvia can tap the principal from their $600,000 muni-bond account. Spending investment principal is psychologically difficult for some retirees, but in many situations it makes good financial sense.

In this case, selling some of their munis now helps Frank and Sylvia avoid taxes later.



Once he reaches 65 and starts receiving Social Security and his pension, they are likely to be in the 28% tax bracket or higher. Money they take out from a regular IRA would be taxed at that rate, and after age 70½ annual withdrawals would be mandatory. That won't be a problem with the assets they've moved into the Roth IRA; they won't have to make withdrawals, but funds they do pull out are tax-free.

In addition, if Frank names his children beneficiaries of the Roth IRA, they will inherit a stream of tax-free income. According to Roth IRA rules, they can stretch out tax-free payments for the rest of their lives.

Future tax breaks: The $100,000 dollar cap for Roth IRA conversions is scheduled to be removed beginning in 2010. What's more, for a conversion occurring in 2010, you can elect to spread out the resulting tax liability over the following two years. ●

Not FDIC Insured, Not a bank deposit or product, May lose value and is subject to investment risk including possible loss of principal.

©2009 API