



# Quarterly Memo

January 2010

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## Estate Tax Holiday is Here!



The unthinkable, the inconceivable, and the patently absurd have actually happened. For now, the US estate and generation skipping

transfer (GST) tax is repealed for 365 days. We've seen it coming since 2001, but 99.9% of professionals were confident that the coming "train wreck" would be resolved far in advance of 2010 by either repeal of the "death tax" or a compromise extension into the future. Yet over the years, legislation to fix the temporary repeal would hit one roadblock after another. One notable occasion was in 2005,

when it appeared the Republican majority had lined up sufficient votes to push through a permanent repeal. Before the vote could be finalized, Hurricane Katrina struck. Louisiana Democratic Senator Mary Landrieu, a key swing vote, suddenly had "higher priorities" and the repeal died. As late as last month, the House passed a permanent extension of the current rules. All Republicans

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## Deciding on a 2010 Roth IRA Conversion

The potential benefits of the Roth IRA are old news – long term tax free compounding in exchange for giving up the up-front tax deduction of traditional deductible IRA's. Roth IRA withdrawals after age 59½ and five years after the account is opened are free from income tax under current law. There are no required minimum distributions (RMD's) beginning at age 70½ as with traditional IRA's. Only your heirs must begin to take periodic distributions. You can convert a traditional IRA into a Roth

IRA by including the converted amount in income with no 10% premature distribution tax.

So what's not to like about a Roth IRA? They have been off limits to many people due to income limitations. In 2009, no Roth contribution was allowed for married couples whose adjusted gross income (AGI) exceeded \$176,000 or for single individuals whose AGI exceeded \$120,000. Converting a traditional IRA to a Roth before 2010 required a modified AGI of

less than \$100,000.

For 2010 and beyond, the contribution limitations remain in place but the conversion limitations are no more. Furthermore, in 2010, conversions are eligible for a special elective deferral and spread of the income – half of the income will be

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## Estate Tax Holiday is Here! (continued from page 1)

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***“There will most certainly be a number of court cases filed by decedents’ estates should a retroactive reinstatement be enacted...”***

voted no, believing that there would not be another opportunity to increase the exemption. Twenty-six Democrats also voted no, either because they agreed with the Republicans or they believed the 2009 \$3.5 million exemption was too generous. The Senate, however, was too occupied with health care legislation to consider the bill. At the last minute, Senate Finance Committee Chairman Max Baucus (D-Montana) tried to obtain unanimous consent to pass a temporary extension. However, this failed when Senate Minority Leader Mitch McConnell objected, saying that a temporary extension would “add further confusion.” (Query: how would Senator McConnell characterize the current situation?) The election of a Republican senator from Massachusetts makes a resolution in 2010 even more uncertain.

As you’re probably aware,

the estate tax returns with a vengeance in 2011, as the exemption amount will fall to only \$1 million. We have heard anecdotes of wealthy individuals on their deathbeds being kept alive on life support past December 31, 2009. Could the horrible converse become reality this coming December? Can Congress pass a bill reinstating the estate and GST tax in 2010? If so, will Congress attempt to make the reinstatement retroactive to January 1? Then the ultimate question is whether a retroactive reinstatement would pass a constitutional test?

The constitutional issue has been the subject of much legal opining. There is precedent from the 1990’s holding that a retroactive estate tax rate increase and the closing of an estate tax “loophole” inadvertently created by Congress were both constitutional. However, the current situation can arguably be distinguished from those cases, as the

current situation involves the repeal of an **entire tax system**. There are cases from the 1920’s when the gift tax was first enacted holding that a tax on gifts completed before the law was enacted did not pass constitutional muster. There will most certainly be a number of court cases filed by decedents’ estates should a retroactive reinstatement be enacted, potentially meaning years of uncertainty to come.

**The possibility of no estate tax in 2010 means that all estate tax documents (wills, trusts) need to be reviewed.**

That is because many documents allocate assets between marital and family trusts or bequests to family members and charities based on formulas incorporating the amount that can pass free of Federal estate tax. For example, a will might leave to a spouse all of the decedent’s estate less

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## Matrix Joins MD Preferred Financial Advisor Network



MD Preferred Service Network, a national internet based physician resource center, working with the National Association of Personal Financial Advisors (NAPFA), has launched the MD Preferred Financial Advisor Network and admitted Matrix as a

member firm. This new program will offer physicians access to Fee-Only financial advisors who act strictly in a fiduciary capacity and who have successfully completed NAPFA’s stringent application and review process. MD Preferred Service Network

has similar networks for selected attorneys, real estate, insurance, travel, and other professionals and provides a number of online resources and services for physicians. For more information, see <http://www.mdpreferredservices.com/>.

## Haiti Donations Eligible for 2009 Tax Deductions

People who give to charities providing earthquake relief in Haiti can claim the donations this year under recently adopted tax provisions, according to the Internal Revenue Service. Taxpayers who itemize deductions on their 2009 return qualify for the special tax relief provision, which was enacted January 22, according to the IRS. Only cash contributions made to these charities after January 11, 2010, and before March 1, 2010, are eligible. This includes contributions made by text message, check, credit card or debit card.

"Americans have opened their hearts to help those affected by the Haiti earthquake," IRS Commissioner Doug Shulman said. "This new law provides an immediate tax benefit for the many taxpayers who have made generous donations."

The new law only applies to cash, as opposed to property, contributions, according to the IRS. The contributions must be made specifically for the relief of victims in areas affected by the January 12 earthquake in Haiti. Taxpayers have the option of deducting these contributions on either

their 2009 or 2010 returns, but not both. To get a tax benefit, taxpayers must itemize their deductions on Schedule A. Those who claim the standard deduction, including all short-form filers, are not eligible.

The IRS noted that taxpayers need to be sure their contributions go to churches, government agencies, or qualified charities. Most organizations eligible to receive tax-deductible donations are listed in a searchable online database available on IRS.gov under "Search for Charities."



## Debt and Deleveraging

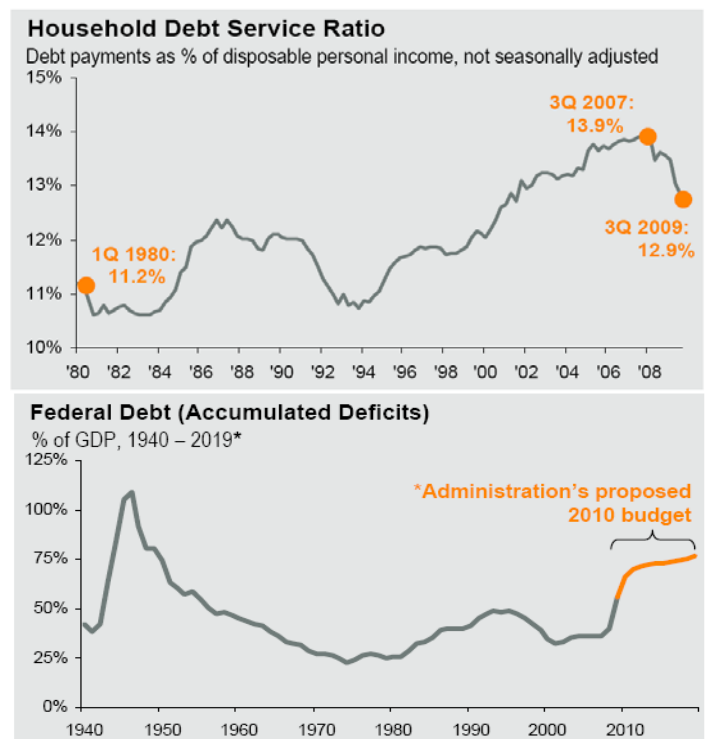
A recent study by the McKinsey Global Institute examined the implications of the worldwide deleveraging process currently underway. The study looked at 45 historic episodes of deleveraging since 1930. The findings may hold some clues as what may await us.

The first finding was that leverage levels are not just a US problem. Many countries face historically high debt levels.

Based on history, a long period of deleveraging nearly always follows a major financial crisis. The periods of deleveraging

have been painful, lasting on average six to seven years and reducing debt-to-GDP ratios by 25%. GDP has historically contracted initially and then recovers. Debt in certain economic sectors tends to contract for a number of years. This contraction acts as a drag on overall GDP growth.

The US appears to be at the beginning of the process. While the household debt situation is improving, this is offset by the explosion of government debt. Therefore, significant deleveraging is unlikely for the next few years.



## Estate Tax Holiday is Here! (continued from page 2)

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***“...the unanticipated result could be a spouse with no inheritance!”***

the amount that can pass free of estate tax. Since the tax free amount is now infinite, one unanticipated result could be a spouse with no inheritance!

For 2010, the gift tax remains in effect at a lower 35% rate. However, if the estate tax is retroactively increased, you can bet the gift tax will, too – probably back to the pre-existing 55-60% maximum rate. That means an individual making a taxable gift now could pay tax at a 35% rate or 60% rate. If the gift also triggers a resurrected but currently suspended GST tax, the math is horrendous – an effective rate exceeding 100%. Making a taxable GST gift currently is the equivalent of tax Russian roulette – the result could be relatively good (a 35% rate) or very, very bad. Clients will have some exceedingly difficult decisions to make with great uncertainty.

Another 800 pound gorilla running amok in the tax planning room right now is “carryover basis.” Under prior law, all property includible in a decedent’s estate (except for retirement plans, annuities, and other “income in respect of a decedent” items) received a new basis in the hands of the person inheriting the property equal to the fair market value on the date of death or six months later, if elected by

the executor. For 2010 only, the law now limits the amount of basis step-up to \$1.3 million plus an additional \$3 million for property passing to a spouse. Carryover basis was actually part of the law briefly in 1976, but was repealed much to the relief of tax practitioners, who dreaded the thought of trying to prove to the IRS what someone paid for property decades earlier. Executors of larger estates will now face that onerous task once again.

Given the fact that we are now living in a zero estate tax environment that no-one thought possible, it would be prudent to consider the next outcome deemed impossible – the return of the estate tax in 2011 with only a \$1 million exemption and a 55-60% top rate. If the congressional game of chicken goes on and the deadlock continues into 2011, a huge number of families could find themselves in need of estate planning.

So what actions should be considered in the midst of the confusion?

**2010 gifts.** If your estate is substantial, consider making taxable gifts in 2010. This will result in a gift tax of 35% if your \$1 million exemption has already been used up. While a 35% tax is substantial, it is far better than the 55% (60% in some cases) rate

scheduled to return in 2011 for estate, GST, and gift taxes. Remember that paying gift taxes is usually preferable to paying estate taxes. That’s because the gift taxes paid reduce the amount of the taxable estate after three years have passed – there is no similar deduction for estate taxes paid. As discussed earlier, GST gifts are another matter with higher risks.

**Conditional GRAT’s.** Some practitioners believe that a grantor retained annuity trust (or GRAT, where the grantor receives an annuity for a term and the remainder goes to beneficiaries) should be permitted to specify whether assets pass to children or grandchildren at the end of the term depending upon whether the GST exists at the time.

**If in doubt, use an ILIT.** The irrevocable life insurance trust (ILIT) is a long established tool for excluding life insurance proceeds from estate taxation. If a much lower exemption returns, using ILIT’s for even modest estates must be considered.

Now more than ever, you need expert guidance in planning your estate. Consulting an attorney experienced and well versed in estate tax matters is not a luxury – it is imperative in 2010.

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## Deciding on a 2010 Roth IRA Conversion (continued from page 1)

reported in 2011 and half in 2012. While this sounds straightforward, the calculations of deciding whether to incur a tax liability now versus later are as convoluted as any planning decision we have ever seen. To get a sense of the complexity, let's examine twelve variables that must be considered:

**1. You and your family's ages.** This determines how soon IRA withdrawals will begin, either for RMD's (you, your spouse, or your heirs) or to fund your cash flow needs.

**2. Your non-retirement assets.** This determines whether you must take withdrawals over and above your RMD's for cash flow needs and whether you will have a source of funds to pay the income taxes generated by a conversion.

**3. Your cash flow needs.** The amount and timing of cash flow needs from your portfolio drive the annual projected withdrawals from your retirement accounts if not satisfied by RMD's.

**4. Your debts.** Mortgage payments require cash flow and may necessitate additional withdrawals from retirement accounts. The after-tax effects will depend upon your interest rate and level of principal payments.

**5. Your tax rate in 2010, 2011, 2012, 2013...** It's not optimal planning to estimate a single tax rate in retirement. First, you

must determine whether the two year 2011-2012 spread will reduce the overall tax impact. Many clients see their income tax rate drop dramatically at retirement only to have it rebound when Social Security benefits begin and even more so when RMD's kick in at age 70½. Only a year by year analysis can truly give an accurate picture of your retirement tax situation. Of course, future tax rates are anyone's guess right now. What will become of ordinary tax rates, capital gain tax rates, dividend tax rates, alternative minimum tax rates, and state tax rates? What would be the effect of a flat tax or the imposition of a value-added tax (VAT)?

**6. Your investment returns.** Higher investment returns tend to favor the long-term tax free compounding of a Roth IRA.

**7. The amount of non-deductible contributions in your IRA.** When you make non-deductible contributions to an IRA, you create an after-tax basis in the account that is tracked annually on Form 8606. This basis reduces the taxable income from a conversion.

**8. Your charitable intentions.** If you plan on leaving all or a portion of your IRA to charity, there's no reason to convert the amount going to charity. IRA proceeds left to charity are not taxed to anyone.

**9. Your estate tax situation.** A conversion probably will result in the payment of income taxes.

Assuming the estate tax returns, paying income taxes now (versus your heirs paying them later) reduces your taxable estate, lowering your estate taxes, and increasing your heirs' inheritance.

**10. Your college financial aid situation.** Converting an IRA increases your adjusted gross income and may affect calculations of potential college financial aid and the expected family contribution. Schools can disregard a Roth IRA conversion if they so choose.

**11. Your portfolio asset allocation.** The composition of your portfolio affects how asset classes are allocated between taxable and retirement accounts, affecting both your tax calculations and expected rates of return.

**12. Your attitude about risk.** Let's face it – this is a risky decision. If you do nothing, you face the risk of substantially higher tax rates in the future that make today's rates look like a bargain. On the other hand, some future Congress could scrap the income tax and substitute a VAT, meaning you paid tax now for no good reason. A future Congress could also decide that Roth IRA's are overly benefiting the rich and pass an "excess Roth accumulations tax" on your heirs or force RMD's like traditional IRA's. (Some historical precedent for this can be found in the now repealed excess

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*“...the calculations of deciding whether to incur a tax liability now versus later are as convoluted as any planning decision we have ever seen.”*

## Taxation of Demutualization Distributions

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**“...returns for 2006  
can still be  
amended through  
April 15, 2010.”**

Do you have any shares of stock in a life insurance company that went through a demutualization? Have you sold any shares after 2005? A demutualization is a transaction in which a mutual insurance company, which is owned by its policyholders, converts into a company owned by stockholders by issuing shares to its policyholders. Thirty-five life insurance companies demutualized from 1986 to 2008 affecting millions of policyholders. Questions arose as to the proper cost basis (if any) for shares received in a demutualization. The IRS position was that the shares had a zero cost basis under the theory that the ownership rights exchanged for the stock had a zero basis. However, a recent court case came to a different conclusion.

In *Eugene A. Fisher et al. v. U.S.* (Ct Cl 8/6/2008) 102 AFTR 2d ¶ 2008-5150, the policy holder had received shares of Sun Life of Canada Holding Corp. through a demutualization. Fisher, upon receipt of the shares, immediately sold 3,892 shares of stock for \$31,759 and paid a capital gain tax of \$5,725 on the entire proceeds from the sale assuming a zero cost basis. Upon further consideration, the shareholder decided that he had paid the insurance premiums on the policy that gave rise to the

distribution of shares and therefore should have a cost basis equal to the value of the stock upon receipt. The policyholder filed an amended return requesting a refund for the capital gains tax paid. The IRS, in keeping with its official position, denied the refund. After beginning in the U.S. Court of Claims, the case ended up with the U.S. Court of Appeals for the Federal Circuit, which ruled in favor of Fisher. The court did not give definitive guidance on how to calculate the cost basis, but relied on the “open transaction” doctrine to allocate basis to the shares equal to their initial fair market value.

The IRS has yet to announce whether it will acquiesce or appeal the Fisher decision to the Supreme Court. What does this mean for you?

If you were a policyholder with an insurance company when it demutualized, you received shares of the insurance company's stock. If you assumed the shares had a zero cost basis and sold the security and reported a capital gain equal to the full value of the shares realized on your tax return, there may be an opportunity to amend your tax return and protect your right to receive a refund. Due to the three year statute of limitations for filing refund claims, returns for 2006 can still be amended

through April 15, 2010. You should contact your CPA promptly if this applies to your particular situation.

If you have not already sold these shares, you may want to defer selling them until a final resolution is determined as to how the cost basis for these shares will be calculated. If a gain applies to the shares and they have been held for more than one year, a charitable contribution could be a good alternative, as your basis is irrelevant.

To view a list of the insurance companies affected, please go to <http://www.demutualization.biz/insuranceCompanies.htm>.

## Some Signs of Recovery Emerge

Even while unemployment persists at 10%, real estate foreclosures rise, and the federal budget deficit balloons to \$1.3 trillion, the nascent recovery nevertheless seems to be taking hold. That is contrary to the popular belief that another dip in the economy and the equity markets are just around the corner. While economic predictions are fraught with peril, facts do indicate an improving economy, at least for a while.

**Capacity utilization,** which fell to 68.3% in June, has climbed for the past six months and now stands at 72%. The long-term average is 82%, meaning there is still considerable slack in the economy.

**Leading economic indicators (LEI).** The Conference Board Leading Indicator Index came in at 1.1% this month versus an expected 0.7%, while the December data was revised up to 1.0% from 0.9%. On a 6-month moving average basis, data going back to 1970 shows that the LEI index has never had such a sustained period of high readings over this 40-year period.

**Business conditions survey.** The Morgan Stanley Business Conditions Index (MSBCI) based on a survey of the firm's equity analysts, kicked off the New Year

on a decisively positive note after finishing 2009 strongly. On a seasonally adjusted basis, the headline index increased 11 percentage points from 71% to 82% in early January – the sixth consecutive reading in expansionary territory. By every metric, this month's canvass hinted at some strength and durability to the current upturn. The price index expanded unequivocally in January – climbing six percentage points to 57% – and the credit conditions index came in at a healthy 67%. In addition, 17% of analysts reported that the companies they follow had expanded payrolls over the past three months. More importantly, each of the MSBCI's forward-looking indicators exhibited marked improvement this month. On the heels of an impressive 18-point increase in December, the advance bookings index surged another 18 percentage points to set a new record high of 89%. Similarly, the business conditions expectations index remained near the all-time high of 88% that it had set last month, and the capital expenditures plans series rose two percentage points to 38%. Finally, the hiring plans series grew ten percentage points to 34% – the highest level for this metric since June 2008.

**Help Wanted Ad index.** The number of online help

wanted ads rose from 3,162,358 in April to 3,641,735 in December. Since the index began in May 2005, the average reading has been 4,049,593.

The **ISM Purchasing Managers Index** is now in solidly positive territory. After reaching a nadir in December 2008 at 32.9, the index now stands at 55.9 and has been above 50 for five consecutive months. A reading above 50 indicates that businesses are expanding.

**New Jobless Claims** fluctuate weekly, but the four week moving average has been rapidly declining since mid-2009. The most recent reading was 441,000, while the number peaked at 658,000 last year.

**Gross Domestic Product.** Finally, GDP did increase last quarter at a 2.2% annual rate. The average rate for the past 20 years has been 2.5%. Most economists expect growth in 2010 to be in that neighborhood or better.

When looking at economic indicators, we tend to view them through our own local lens, which might not be representative of the entire country. Many serious threats to long-term economic growth remain, but for now, the picture is looking brighter.

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*“...facts do indicate an improving economy, at least for a while.”*

## Deciding on a 2010 Roth IRA Conversion (continued from page 5)

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distributions tax and the excess accumulations tax.) Congress could even decide to partially or completely do away with the tax free status of withdrawals. (It was not that long ago that Social Security benefits were completely tax free – remember?) A decision to make a Roth conversion is essentially telling the Federal government that you trust it to deliver the future tax benefits you expect to receive. While some of these ideas may seem far-fetched, we are talking about taxes as they may exist in 30, 40, or 50 years from now.

**How can we help?** For Matrix planning clients, we

intend to run detailed Monte Carlo simulations on various Roth conversion scenarios in our planning software. While this will require considerable effort, it should help you make the best possible decision given the many variables involved. For our investment clients who would like assistance with this decision, we will use standalone Roth IRA conversion analysis software. We can also recommend web sites if you would like to test your own multiple scenarios.

**All or nothing?** Many advisors are advocating “tax diversification” – retaining some traditional

IRA assets while converting only a portion to a Roth IRA. That way, you won’t be completely wrong no matter what happens with future taxes and rates.

**Consult your CPA.** As always, in any decision involving taxes, your CPA should be an integral part of your advisory team and you should carefully consider his/her opinion and advice. We will provide your CPA with our analysis for his/her review and try to answer any questions.

**You can change your mind.** Roth conversions in 2010 can be “undone” through October 15, 2011.

### About Matrix Wealth Advisors, Inc.

Planning is the process of allocating limited resources among unlimited alternatives according to a system of values to achieve life goals.

Founded in 1990, Matrix uses a very personalized, principle-centered wealth management process to offer comprehensive financial planning and investment advisory

services that help clients take action to achieve their goals. Matrix is a fee-only, fiduciary firm and is compensated solely by our clients.



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