VESTPOINTEWEALTH
MANAGEMENT

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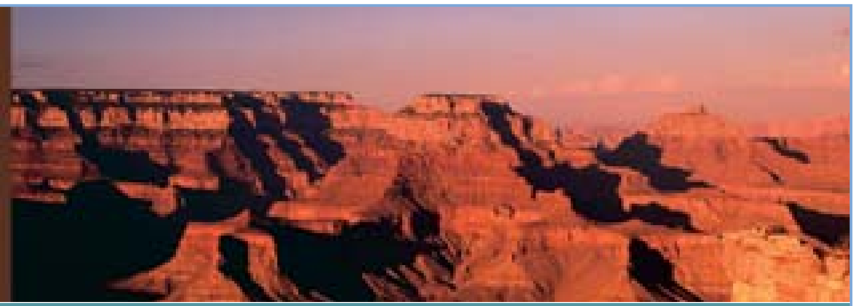

Retirement Rules Change Again, Mostly For The Better

What's in a name? The Pension Protection Act of 2006, signed into law in August 2006 did a lot more than shore up company-sponsored pension plans. Among other things, the legislation stiffened some rules for charitable giving and relaxed others. It permanently establishes several taxpayer-friendly laws that were set to expire after 2010, such as allowing older savers to make catch-up contributions to retirement plans. And it rendered some strategies more attractive than ever. While many of the act's provisions don't kick in for years, others dictate immediate attention. Here are moves to consider.

Roll over an inherited 401(k). Beneficiaries who inherit a 401(k) from someone other than a spouse can transfer the funds to an inherited IRA beginning in 2007. That lets you withdraw the money over your lifetime. Because the withdrawals are taxable, this change is a distinct advantage over old rules that mandated emptying the account in five years or less.

The 401(k) trustee must transfer the funds directly to the bank or investment company holding the IRA—you can't touch the money. There are also rules about how the new account must be titled—"John Smith, Sr. Deceased IRA, For the Benefit of John Smith, Jr." Tranferring the funds to your regular IRA won't work.

Give your IRA distribution to charity. It's always been possible to leave an IRA to charity at death. Now, only during 2006 and 2007, there's another option. During each of those years, if you've reached age 70½, you can distribute up to $100,000 from your IRA directly to a tax-exempt organization (though not to a private foundation or donor-advised fund).

The money must move directly from the IRA custodian to the charity. The withdrawal counts toward your required minimum distribution, so instead of deducting it as a charitable donation, you simply don't include it in income for the year. That's particularly valuable if you don't itemize, or if your charitable-contribution deductions have been limited for other reasons. You'll reap tax savings you couldn't get otherwise.

Hold a garage sale. Effective immediately, donations of used clothing and household goods to charity are deductible only if they are in "good condition." The law's language is decidedly vague, but its intent to restrict deductions for these items is clear. Selling them might be better.

Document all cash gifts. Beginning in 2007, merely saying you contributed to a charity (for example, the donation box at church) won't get you a deduction. You'll need proof such as a bank statement or cancelled check, or a receipt from the charity indicating its name, the amount you gave, and when.

Weigh advice carefully. If you participate in a 401(k) at work, the new law allows your company to give you access to advisors from the plan provider (normally a mutual fund or insurance

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What Is The No. 3 Certainty After Death And Taxes?

If death and taxes are life's two certainties, then death taxes being a mess is No. 3. Proposed legislation that would have stream-lined and clarified the Federal estate tax recently failed. As a result, the future of the death tax remains one of life's great uncertainties.

The proposal, had it been enacted, would have replaced the intricate system of estate tax rates, ranging from 18% to 46%, with a simple "capital gains" model. Estates valued at under $5 million would have been exempt from Federal tax; the federal government would claim a 15% share of estates worth between $5 million and $25 million and 30% of larger estates. Alas, simplification was not adopted.

What's unfortunate here is not so much the financial impact on heirs, but the fact that Congress again missed a chance to provide guidance to those trying to ensure a smooth transfer of an estate.

Under current law, estate taxes are gradually phased out between now and 2010, and there is no estate tax in 2010. But in 2011, the estate tax is revived, and it reverts to higher rates and lower exemption amounts. Since the current rules make little sense, everyone figures they must be changed. Will the estate tax be permanently repealed? No one knows.

Estate tax planning remains complex. For now, the best solution is to review your estate tax status every year or two. If you have not done such a review in recent years, you've already waited too long.

Shaping Your Legacy With Trusts

Like many affluent baby boomers, Paul Schervish and his wife worry about the impact of their wealth on their children. So, instead of leaving the three kids a lump-sum inheritance, they've structured a trust that will distribute its holdings "like a good parent," providing support for home buying, education, and health care.

As director of Boston College's Center on Wealth and Philanthropy, Schervish knows he's hardly alone in his concerns. As families participate in the biggest wealth transfer in history, estimated at more than $45 trillion, "they're trying to figure out how to make inheritances productive, not destructive," Schervish says.

That often means employing one or more trusts. Though frequently touted for their tax benefits, trusts can also help preserve and protect wealth and enable parents to exert control over children's lifestyles. The irrevocable nature of most trusts can provide substantial protection from divorcing spouses, medical malpractice judgments, and other claims by creditors.

Trusts are almost infinitely flexible. "You can write just about any trust provision you want, and some people set very specific requirements that have to be met before payouts are made—that a child attend a particular college, say, and receive a set grade point average," says Jeffrey Condon, co-author with his father Gerald Condon of *Beyond the Grave: The Right Way and the Wrong Way of Leaving Money to Your Children (and Others).*

Trusts can protect assets from creditors and ensure that your wishes are carried out

Getting that specific is usually a mistake, says Condon, though he does encourage clients to consider establishing solid criteria for how beneficiaries—a spouse, children, grandchildren, or even those in succeeding generations—gain access to trust assets. Condon believes such restrictions are preferable to the common practice of simply staggering payouts—for example, giving beneficiaries a third of their share at age 30, another at 35, and the rest at 40. "Heirs can blow those installments just like any other windfall," he says.

To help protect a "problem" child, who may have a drug or alcohol habit, a trust could put a great deal of control in the hands of a professional trustee, such as a bank or trust company, that will not only oversee trust investments but also cut the checks for all beneficiary expenses. Sometimes, trust provisions also call for a third party, a family friend or relative, to help assess an heir's needs and keep the professional trustee informed.

But Condon warns against a "carrot and stick" approach that imposes too many conditions. "No matter how well such trusts are drafted, everyone may wind up in court, with the kid saying he or she has met the conditions and the trustee saying the heir hasn't." A better solution, in such cases, Condon says, is simply to limit the payout. "That way, the heir knows this is all that's coming. Sometimes, the best you can do is hope your children's lives will be happy. Trusts can do many things, but they can't force your children to live the way you want when you're no longer around." ●

Tax Law Now Allows Those Inheriting Retirement Plan Assets

Most 401(k)s and other employer-sponsored retirement plans are bequeathed to spouses, and with good reason. Until a recent change in rules, only a spouse could inherit a retirement plan other than an IRA and avoid immediate taxes. Now, although the process must be handled carefully, any beneficiary should be able to receive a retirement plan and enjoy the same tax-postponing benefits that a husband or wife always could.

Under the old rules, if your husband got the money, fine; he could roll over the windfall into his own IRA and make withdrawals over the course of his expected lifespan. Though each year's required distribution would add to his taxable income, the rest of the account would continue to compound, and there might be a sizable balance left at his death.

But your daughter? Most employer plans require an account to be emptied within five years of an employee's death. She would have had to take the money and, not being allowed to move it into an IRA, would have been stuck paying income tax immediately—and likely would have lost a third or more of her inheritance to taxes in the process.

The new rules are much kinder to non-spouse beneficiaries. Now, should you choose to leave your 401(k) to a child, a same-sex partner, or anyone else, that person may roll over the inherited plan to an IRA. But the law is prickly about the process. To make a successful rollover, your heir must:

- Open an inherited IRA to take the money. A spouse who inherits a 401(k) can merge the account with her own IRA, but others must set up a new account specifically created to receive funds transferred from the deceased's retirement plan.
- Be sure to title the new account correctly. For instance, Dad IRA (Deceased) FBO Daughter.
- Make sure the money goes directly from the company plan to the

Do Investment Benchmarks Matter?

Champagne was flowing on Wall Street in October when the Dow Jones Industrial Average hit a string of record highs. But should you be popping corks? Only if your entire portfolio is invested in the 30 stocks that make up that index, says Russel Kinnel, director of mutual fund research at Morningstar Inc. in Chicago. Even then, considering the Dow took almost seven years to regain ground lost since early 2000, there might not be much to cheer about.

The real trouble with headline-grabbing market benchmarks is they say very little about how your own portfolio is doing and even less about whether your financial plan is on track to meet your personal goals. For that, you need a personalized set of benchmarks based on your goals, risk tolerance, and time horizon. And because no two financial plans look exactly the same, no cookie-cutter benchmarks can help you track your individual progress.

"You have to set your own expectations and goals," Kinnel says. To monitor your investments effectively, you have to know why you chose a particular investment and what you hope to accomplish.

Part of the problem is that the performance of different stock market segments may vary widely, and year-by-year gains and losses are unlikely to form a consistent pattern. For example, consider the wide differences between the Standard & Poor's 500, one of the best benchmarks for large-cap stocks, and the Russell 2000, which tracks the small-cap sector. Through October 2006, the S&P 500 posted a 12-month return of 17.73%, while during the same period the Russell racked up 9.2% in gains. Yet during the past five years, the S&P has an annualized return of 6.62%, less than half of the 13.78% yearly advance of the small-cap index, according to Morningstar.

Your own portfolio is likely to exhibit the same kind of variability, making it all the more important to remember you're in this for the long haul. "You can't say my goal is to have my portfolio return 7% a year and then panic because one year it didn't make that," Kinnel says. "You have to have a long-term perspective, keeping focused on your long-term goals."

Moreover, total returns are only part of the equation. There's also the matter of how much risk you are willing to assume to reach target returns. Every asset class has its own risk-return profile based on historical returns and volatility. And because different asset classes tend to outperform during different market cycles, it is important to hold a variety of investments that balance out your own risk-return profile over the long term.

For example, looking at the past five years, ending October 31, 2006, large-cap value stocks posted an average annualized return of 2.91%, compared with 6.14% for the small-cap growth sector, according to Ibbotson Associates, a Morningstar company. But during that same period, small-cap growth was significantly more volatile, posing more risk for investors. Ibbotson measures volatility according to the variability (standard deviation) of returns of an asset class. The standard deviation for large-cap value was 19% during the past five years, easier to take than the 28.02% standard deviation of small-cap growth.

Volatility can have a tremendous impact on long-term performance. For example, if a $100 stock drops 25% to $75, it must climb 33% just to get back to its starting point. If the same stock drops 10%, it needs only an 11% gain to break even.

A diversified portfolio, done properly, dampens volatility by incorporating a variety of assets and may post positive returns even when indices such as the Dow and S&P 500 are struggling. But diversification also makes it difficult to track individual progress against a public benchmark.

"It's helpful to know what the market has done to put your portfolio in context," Kinnel says. "If the S&P 500 has gone up 20% and your large blend fund was up only 10%, you might want to take a look at why it didn't meet that benchmark."

But the answer could be that the S&P carried more risk than your fund—and more risk than you're comfortable taking on. A more important question is whether you're on track to achieve individual goals.

To help you understand your portfolio's returns, and the role of your investments in meeting your financial objectives, we can provide a comprehensive portfolio analysis that measures your progress against personal investment goals. The individualized benchmarks we establish will be much more meaningful than what happens to the Dow. ●

Rates of return for indexes noted in this article are not the returns of actual portfolios. An investment in those categories or classes of investments will not return exactly the same as the return on the category benchmark, and the past performance is not an indication of your future returns.

To Retain Tax Deferral Much Longer

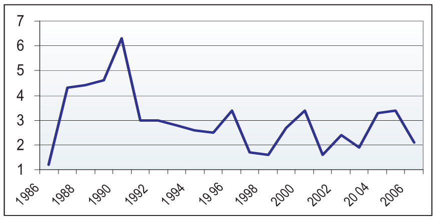
heir's new IRA. If your beneficiary touches the money, he or she will be immediately taxed.

Keep in mind that it doesn't matter when the account owner dies as long as the beneficiary postpones the rollover until 2007. So if the account owner died in 2006, an heir can benefit from the new rules as long the rollover is made in 2007.

If you've ever changed jobs, you may already have transferred retirement funds from your former employer to an IRA. Until the rules changed, that was the only way to ensure favorable tax treatment for a non-spousal heir. And even now, a rollover is often advisable. IRAs tend to offer a wider range of investment options than you get in a typical 401(k), and it's easier to monitor investments in a single account.

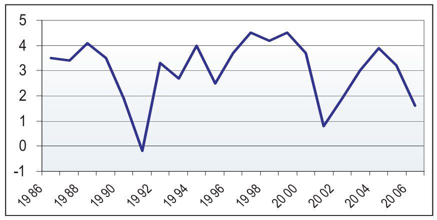
There is at least one advantage to keeping money in a 401(k), however. If you retire, you may begin taking distributions from an employer plan at age 55 without incurring the 10% early withdrawal penalty you would owe for withdrawing assets from an IRA before age 59½. Under the new rules, you can have the penalty-free early access of a 401(k) while also accommodating non-spousal heirs. ●

Economy Watch: 3rd Quarter 2006



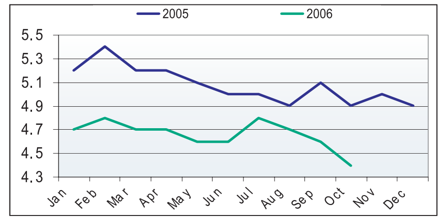
US Ecomonic Growth

Thanks to the combined effect of higher interest rates, energy prices, and a weakening housing market, economic growth slowed substantially in Q3 to an annualized rate of 1.6%, according to preliminary estimates.



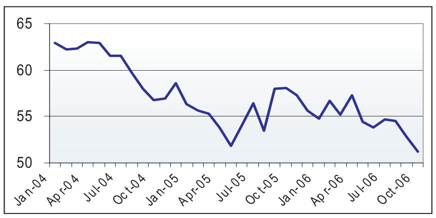
Inflation

Overall, consumer inflation followed soaring gas prices higher over much of the summer and then ebbed as energy markets went on the retreat. By quarter end, the CPI was up a subdued 2.1%, well below long-term norms.



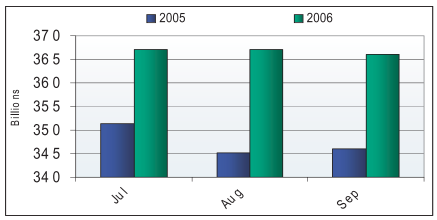
Jobs

Competition for skilled workers remained intense, a sign of continued healthy economic activity but feeding fears of inflating wages ahead. The unemployment rate fell to a five-year low of 4.4% in September



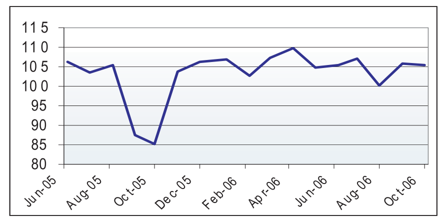
Manufacturing Growth

The U.S. industrial sector continued to grow but at a slower rate in Q3, thanks in part to a slowdown in auto production. The Institute of Supply Management's manufacturing growth index slid from 54.7 to 51.2.



Consumer Spending

While American appetites for goods and services appear as sharp as ever (hitting a high of $367 billion a month in Q3), lower prices at the gas pump curbed aggregate retail spending somewhat.



Consumer Confidence

Falling gas prices also helped to brighten consumers' outlook. The Conference Board's consumer confidence index slumped in July but rebounded in September, ending the quarter almost where it began.

Data for the CPI, Unemployment Rate and Non-farm Payrolls are from the Bureau of Labor Statistics. Data for the GDP are from the Bureau of Economic Analysis. The Purchasing Managers Diffusion Index is a release of the Institute of Supply Management. Retail spending data are from the Bureau of the Census. Data for Consumer Confidence comes from the Conference Board.

Changing Retirement Rules

(Continued from page 1)

company). Make sure any advice is consistent with the objectives of your financial plan.

Consider an in-service distribution. The new law lets participants in company-paid pensions who are at least age 62 receive benefits from the plan even if they're still working. Previously, you had to be 65.

Diversify employer stock. The legislation makes it easier for workers at public companies whose retirement plans offer the company's stock to sell their shares. That should help you keep your portfolio from becoming dangerously over-concentrated.

Donate a conservation easement. The income-tax deduction for placing a permanent conservation easement on property and donating it to a qualifying organization was formerly limited to 30% of income for the year, with the remainder deductible over the following five years subject to the same restriction. Now, just for 2006 and 2007, you can deduct up to 50% of income (100% for certain farmers and ranchers), and you get 15 years to use the deduction.

Get ready for the Roth 401(k). The law permanently establishes the Roth 401(k), a new type of retirement account that came into existence in 2006 but had been authorized only through 2010. Now, more employers are expected to offer it. You may contribute after-tax dollars to a Roth 401(k) regardless of your income, and investment earnings may be withdrawn tax-free after five years if you're at least age 59½.

In 2006, workers may put a maximum of $15,000—or $20,000, if you're at least 50 by year end and your company allows catch-up contributions—in all 401(k)s. Whether your money should go to a traditional 401(k) or a Roth hinges largely on your current and future tax brackets. In general, if you expect to be in the same or a lower bracket when you withdraw money from the account during retirement, a traditional 401(k) is preferable because it delays the tax. If you may be in a higher bracket when you retire, the Roth may be better, though when you expect to quit working also factors into the analysis. ●

Material is for informational purposes only, not to be construed as tax, legal, or investment advice. Information has been gathered from sources believed to be reliable, but individual situations can vary and you should consult with an investment, legal, accounting or tax professionals.

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