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Roth IRA Conversion Opportunities Unfold for 2010

The Taxpayer Relief Act of 1997 added Code section 408A, which created a new type of Individual Retirement Account, known as Roth IRAs. The basic premise of the Roth IRA is that there is no tax deduction for contributions going in, and no income tax due on money coming out, as long as qualified conditions are met, which include:

- The Roth IRA has been in existence for five years, and
- Distribution occurs after the account holder attains age 59 ½, or after death or disability of the individual, or for a first time homebuyer (\$10,000 limit).

However, many high-income Americans have been denied the ability to establish or fund a Roth IRA due to several long-standing rules. Current law prevents married couples with Adjusted Gross Income (AGI) above \$176,000 from contributing to a Roth IRA. In addition, only taxpayers whose modified AGI is \$100,000 or less may convert amounts in a traditional IRA to a Roth IRA.

A new tax law provision regarding Roth IRA conversions becomes available in tax years after 2009. Americans will be able to qualify and consider a Roth IRA conversion regardless of their income level, as the modified AGI limit on conversions is eliminated. An additional wrinkle involves Roth IRA conversions made in 2010; the taxpayer can choose to be taxed on the entire conversion in 2010, or may defer the taxability of the conversion equally between 2011 and 2012. The decision to tax a conversion will require careful considerations; as we watch tax legislation unfold, that will likely impact changes to individual income tax rates.

Although it is obvious that a Roth IRA is a solid choice for a taxpayer who expects to be in a higher tax bracket in their retirement years, the greatest

benefit of a Roth IRA may be in transferring wealth to heirs. A Roth IRA is not subject to Required Minimum Distributions at age 70 ½, which can become an appealing vehicle to accumulate assets on a tax-free basis for the owner's lifetime and surviving spouse. In turn, the income tax-free nature of the Roth can be preserved for one more beneficiary generation's lifetime (i.e., child or grandchild), as the only distribution requirement for them is to take distributions based upon their life expectancy. This can stretch the Roth's tax-free duration for decades.

There are a variety of other scenarios where a Roth IRA can be advantageous. Taxpayers with large estates can reduce their estate tax exposure by incurring the income tax consequence from a conversion; paying the income tax from a conversion is akin to adding extra value to your retirement plan account. Investment accumulations in a tax-free Roth environment can exceed the accumulation value of an IRA with time, even after incurring the income tax from the conversion.

Although the law change provides significant opportunity, one must emphasize the importance of doing sound financial planning in thinking through the possibilities. Many providers have software tools that can make planning calculations for these retirement plan considerations or conversions, and provide a sound resource for your planning needs. ■

CONTACT

- Talk to your local Eide Bailly financial advisor
- Call 866.740.4100 for more information



Retirement Plans Most Appropriate for Self-Employed/ Sole Proprietorship/Partnership

OVERVIEW

If you are self-employed or involved with a small business (e.g., a partnership or sole proprietorship), establishing a retirement plan can provide benefits for you as well as any employees you may have. This article will help you determine the most appropriate retirement plan for your situation.



In contrast to qualified plans, non-qualified retirement plans are often not subject to the same set of ERISA and IRC guidelines. As you might expect, this freedom from extensive requirements often provides non-qualified plans with greater flexibility for both employers and employees.

Introduction

Retirement plans offer a number of benefits. A typical plan provides participating employees the opportunity to systematically save for retirement. From the employer's point of view, having a retirement plan can maximize the business's profitability by helping to attract and retain quality employees, and by boosting employee productivity. In addition, in the case of qualified plans and some non-qualified plans, retirement plans can provide significant tax advantages for both employer and employees.

If you are self-employed or involved with a small business (e.g., a partnership or sole proprietorship), establishing a retirement plan can provide benefits for you as well as any employees you may have. As you know, however, small businesses and self-employed individuals have considerations very different from those of large employers. The best retirement plan for a large corporation may not be the best one for a small business with a few employees. Certain types of retirement plans are generally considered more appropriate for small businesses and self-employed individuals.

Caution: *If you have employees and wish to establish a retirement plan for your small business, be aware that you will typically be required to cover some (if not all) of your employees under the plan.*

Qualified Versus Non-Qualified Plans

As mentioned, qualified retirement plans (like 401(k), profit-sharing, stock bonus, defined benefit and hybrid plans) offer significant tax advantages to both employers and employees. Employers are generally permitted to deduct their contributions on their federal income tax returns, while participants can benefit from pretax contributions and tax-deferred growth. In return for these tax benefits, a qualified plan must adhere to strict IRC (Internal Revenue Code) and ERISA (Employee Retirement Income Security Act) guidelines regarding participation in the plan, vesting, funding, nondiscrimination, disclosure and fiduciary matters.

In contrast to qualified plans, non-qualified retirement plans are often not subject to the same set of ERISA and IRC guidelines. As you might expect, this freedom from extensive requirements often provides non-qualified plans with greater flexibility for both employers and employees. In addition, non-qualified plans are often less expensive to establish and maintain than qualified plans. Generally, the main disadvantages of non-qualified plans are (a) they are typically not as beneficial as qualified plans from a tax standpoint, (b) they are generally available only to a select group of employees, and (c) plan assets are not protected in the event of the employer's bankruptcy. For these reasons, qualified plans usually appeal to the largest number of employers and employees.



Specific types of retirement plans

The following types of retirement plans are generally considered most appropriate for self-employed individuals and small businesses:

- **Payroll deduction IRA plan:** A payroll deduction IRA plan is a type of arrangement that you can establish to allow your employees to make payroll deduction contributions to IRAs (traditional or Roth). It can be offered to your employees instead of a more conventional retirement plan (such as a 401(k) plan), or to supplement such a plan. Each of your participating employees establishes and maintains a separate IRA, and elects to have a certain amount deducted from his or her pay on an after-tax basis. That amount is then invested in the participant's designated IRA. Payroll deduction IRAs are generally subject to the same rules that normally apply to IRAs.
- **SEP plan:** A simplified employee pension (SEP) plan is a tax-deferred retirement savings plan that allows contributions to be made to special IRAs, called SEP-IRAs, according to a specific formula. Generally, any employer with one or more employees can establish a SEP plan (although it is best suited for the self-employed, or a sole proprietor or partner with net business income). With this type of plan, you can make tax-deductible employer contributions to SEP-IRAs for yourself and your employees (if any). Except for the ability to accept SEP contributions from employers (allowing more money to be contributed) and certain related rules, SEP-IRAs are virtually identical to traditional IRAs.
- **SIMPLE IRA plan:** A SIMPLE IRA plan is a retirement plan for small businesses (generally those with 100 or fewer employees) and self-employed individuals that is established in the form of employee-owned IRAs. The SIMPLE IRA plan is funded with voluntary employee contributions and mandatory employer contributions. The annual allowable contribution amount is significantly higher than the annual contribution limit for traditional and Roth IRAs. Employer contributions to this type of plan are tax deductible for the employer, and are excluded from the employee's current income.

- **SIMPLE 401(k) plan:** A SIMPLE 401(k) plan is a retirement plan for small businesses (generally those with 100 or fewer employees) and self-employed individuals, including sole proprietorships and partnerships. This type of plan is structured as a 401(k) cash or deferred arrangement (CODA), and was devised in an effort to offer self-employed individuals and small businesses a tax-deferred retirement plan that is similar to the traditional 401(k) plan, but with less complexity and expense. Employer contributions to this type of plan are tax deductible for the employer, and are excluded from the employee's current income.
- **Keogh plan:** A Keogh plan (sometimes referred to as an HR-10 plan) is a qualified retirement plan for self-employed individuals and their employees. Only a sole proprietor or a partnership may establish a Keogh plan; an employee or an individual partner cannot. Keogh plans may be set up as either defined benefit plans or defined contribution plans.

***Tip:** The 401(k) plan has become increasingly popular for sole proprietors and solely owned corporations. With individual 401(k) plans (which are also known as solo 401(k)s, employer-only 401(k)s, single participant 401(k)s and mini 401(k)s), the business owner is typically the only participant in the plan. The appeal of individual 401(k) plans dramatically increased as a result of the Economic Growth and Tax Relief Reconciliation Act of 2001, which (a) increased the maximum deductible profit-sharing contribution from 15 percent to 25 percent, and (b) allowed employee 401(k) deferrals to be deducted separately, in addition to the maximum profit-sharing contribution. These changes allow a much larger deductible contribution than was permitted under prior law. As a result, significant dollars can now be contributed, tax deferred, for the benefit of the business owner. ■*



A payroll deduction IRA plan is a type of arrangement that you can establish to allow your employees to make payroll deduction contributions to IRAs (traditional or Roth). It can be offered to your employees instead of a more conventional retirement plan (such as a 401(k) plan), or to supplement such a plan.

CONTACT

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OVERVIEW

This article provides a general overview of IRAs, to help you make informed decisions about your retirement account options.

IRAs

What is an Individual Retirement Account (IRA)?

An individual retirement account (IRA) is a personal savings plan that offers specific tax incentives to encourage you to save for retirement. Currently, there are two types of retirement IRAs. Traditional IRAs allow for tax-deductible contributions under certain conditions. Roth IRAs (created by the Taxpayer Relief Act of 1997) are funded with after-tax dollars, but may allow for tax-free withdrawals under certain conditions.

It is important to realize that an IRA is not itself an investment, but a tax-advantaged vehicle in which you can hold some of your investments. You need to decide how to invest your IRA dollars based on your own tolerance for risk and investment philosophy. How fast your IRA dollars grow is largely a function of the investments that you choose.

***Tip:** The term “IRA” can refer either to an individual retirement account or an individual retirement annuity. An individual retirement annuity is an annuity or endowment contract that you purchase from a life insurance company. The contract must not be transferable, and the premiums must be flexible so that if your compensation changes, your premium payments can also change. In general, the same rules that apply to individual retirement accounts also apply to individual retirement annuities.*

Overview of IRA Types

Traditional IRAs

Prior to 1997, there was only one type of IRA. Because it was the only type, it didn't have a special name—it was simply called an IRA. However, as a result of the Taxpayer Relief Act of 1997, this “original” IRA came to be called the “traditional” IRA to distinguish it from the newly created Roth IRA.

A traditional IRA is a special type of personal savings plan that provides certain tax advantages to encourage you to save money for retirement. For 2009 and 2010, you can contribute up to the lesser of \$5,000 (\$6,000 if age 50 or older) or 100 percent of your taxable compensation to a traditional IRA. You may also be able to

contribute up to the same amounts to a traditional IRA for your spouse. Funds in a traditional IRA grow tax deferred until they are paid out to you.

There are two types of contributions that you can make to a traditional IRA: deductible contributions and non-deductible contributions. When you make deductible contributions, you reduce your taxable income for the year, so the dollars that you contribute are pre-tax. Those dollars will not be taxed until you withdraw them from the IRA. When you make non-deductible contributions, you contribute after-tax dollars that will not be taxed again later when you withdraw them from the IRA. The portion of any withdrawal that represents investment earnings is always taxed.

Your ability to make a deductible contributions to a traditional IRA depends on your annual income, your income tax filing status and whether you (or, in some cases, your spouse) are covered by an employer-sponsored retirement plan.

Roth IRAs

As mentioned, the Roth IRA is a product of the Taxpayer Relief Act of 1997. Like traditional IRA funds, funds held in a Roth IRA enjoy tax-deferred growth. But the Roth IRA is often described as the opposite of a traditional IRA because other key features differ. Roth IRA contributions are never tax-deductible (you can contribute only after-tax dollars), but withdrawals may be completely tax free if you meet the requirements for qualifying withdrawals. For 2009 and 2010, you can contribute up to the lesser of \$5,000 (\$6,000 if age 50 or older) or 100 percent of your taxable compensation to a Roth IRA. You may also be able to contribute up to the same amounts to a Roth IRA for your spouse.

You may or may not qualify to establish a Roth IRA. Even if you do, you may not qualify to contribute up to the annual maximum. Whether or not you can contribute to a Roth IRA depends on your annual income and your income tax filing status.



For 2009 and 2010, you can contribute up to the lesser of \$5,000 (\$6,000 if age 50 or older) or 100 percent of your taxable compensation to a traditional IRA. You may also be able to contribute up to the same amounts to a traditional IRA for your spouse. Funds in a traditional IRA grow tax deferred until they are paid out to you.

Spousal IRAs

If you file your federal income tax return as married filing jointly and meet certain other conditions, you can contribute to an IRA (traditional or Roth) for your spouse even if he or she has little or no taxable compensation of his or her own for the year of the contribution. This is usually described as making a contribution to a spousal IRA. A spousal IRA is not, however, a special type of IRA. It is merely a way of describing the fact that you are making a contribution to your spouse's traditional or Roth IRA.

SEP IRAs and SIMPLE IRAs

A Simplified Employee Pension Plan (SEP) is a retirement plan an employer can establish for employees (self-employed individuals can also adopt a SEP plan). Employer SEP contributions, which can be as high as \$49,000 a year for each employee (in 2010), are made to employee traditional IRAs (usually called SEP IRAs). All of the rules applicable to traditional IRAs apply to SEP IRAs. In addition, employees can make their own traditional (but not Roth) IRA contributions to their SEP IRAs, subject to regular traditional IRA rules and contribution limits.

A Savings Incentive Match Plan for Employees of Small Employers (SIMPLE IRA plan) is also an employer-sponsored retirement plan. With a SIMPLE IRA, both the employer and the employees make contributions to SIMPLE IRAs established for the employees. SIMPLE IRAs are different from traditional IRAs—employees can't make regular IRA contributions to SIMPLE IRAs. After an employee participates in the SIMPLE plan for two years, however, the employee can roll the SIMPLE IRA assets into a traditional IRA.

Deemed IRAs

Employers who maintain certain retirement plans (like 401(k), 403(b), or 457(b) plans) can allow employees to make regular IRA contributions—traditional or Roth—to special accounts set up under their retirement plan. These accounts, called “deemed IRAs,” function just like regular IRAs. Advantages include the fact that your retirement assets can

be consolidated in one place, contributions can be made automatically through payroll deduction, the employee can take advantage of any special investment opportunities offered in the employer's plan and protection from creditors may be greater than that available in a standalone IRA. The downside is that investment choices in an employer's plan may be very limited in comparison to the universe of investment options available through a separate IRA. Also, the distribution options available to employees and their beneficiaries in a deemed IRA may be more limited than in a stand alone IRA. Because of the administrative complexity involved, most employers have so far been reluctant to offer these arrangements under their retirement plans.

Rollovers and Transfers

You can shift funds from one traditional IRA to another traditional IRA or from one Roth IRA to another Roth IRA. You can do this by having the trustee or custodian of one IRA transfer the funds directly to the trustee or custodian of a second IRA without ever distributing the funds to you. You can also arrange for the trustee or custodian of your IRA to distribute your funds to you. To avoid taxes and penalty, you then roll the funds over into another IRA (of the same type) by contributing the funds to that IRA within 60 days after receiving the distribution from the first IRA (the IRS can waive this 60-day rule under limited circumstances, such as proven hardship). Shifting funds from a traditional to a Roth IRA is more complicated.



If you file your federal income tax return as married filing jointly and meet certain other conditions, you can contribute to an IRA (traditional or Roth) for your spouse even if he or she has little or no taxable compensation of his or her own for the year of the contribution.



IRAs—from page 5

Tip: *You may roll over funds from an employer's qualified retirement plan to a traditional IRA.*

Premature Distribution Tax

You decide when and how much to withdraw from your traditional and Roth IRAs, but taxes and penalties imposed by the federal government will likely influence your decision-making process. A 10 percent premature distribution tax is generally assessed on the taxable portion of any distribution you take from a traditional or Roth IRA prior to age 59½. This tax is over and above regular federal income tax. There are a number of exceptions to the tax, however.

Caution: *Special rules apply if you convert or roll over funds from a traditional IRA to a Roth IRA and later withdraw funds from that Roth IRA.*

Required Minimum Distributions

Like many people, you may want to keep your funds in your IRAs for as long as possible to maximize tax-deferred growth and/or preserve the funds for your beneficiaries. Unfortunately, the federal government does not allow you to do this. The required minimum distribution rule states that when you reach age 70½, you must begin taking minimum annual withdrawals from your traditional IRAs (this rule does not apply to Roth IRAs). These annual withdrawals are based on a life expectancy calculation and are intended to dispose of your traditional IRA balance over a given period of time. You can always withdraw more than the required minimum in any year, but if you withdraw less, you will be subject to a 50 percent penalty on the shortfall.

The Importance of Beneficiary Choice

When you open a traditional or Roth IRA, you have to designate a beneficiary. This is the person or entity that will receive the funds remaining in your IRA after you die. It can be your spouse, a child or grandchild, a friend or other relative, a trust, a charity, your estate or some combination of these (you can have more than one designated beneficiary). Obviously, your beneficiary should be someone you wish to provide for financially. What you may not realize is that choosing a beneficiary involves other important considerations. Your choice

will determine how quickly the IRA funds must be distributed after your death, and could even impact the required minimum distributions that you must take from a traditional IRA during your life (if you choose a spouse who is more than 10 years younger than you).

Investment Choices Appropriate for IRAs

Remember that an IRA is not itself an investment, but a tax-advantaged vehicle in which you can hold some of your investments. Choosing specific investments to fund your IRAs is an important decision. Here are some points to keep in mind:

- You need to decide how to invest your IRA dollars based on your own retirement goals, tolerance for risk, investment philosophy and other personal factors.
- How fast your IRA dollars grow is largely a function of the investments that you choose, as well as tax deferral.
- There are specific types of investments that you cannot use to fund your IRAs (such as collectibles), and there are some choices that usually make more sense as IRA investments than others (e.g., mutual funds, CDs).
- If you're unhappy with your IRA investment choices, you can typically move your money to other investments offered by the same financial institution, or to a different institution.
- You should consider any fees associated with opening and maintaining your IRA.

Caution: *The IRS has ruled that the wash sales rules apply if you sell stock or other securities outside of your IRA for a loss, and purchase substantially identical stock or securities in your IRA (traditional or Roth) within 30 days before or after the sale. The result is that you cannot take a deduction for your loss on the sale of the stock or securities. In addition, your basis in your IRA is not increased by the amount of the disallowed loss. ■*

CONTACT

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The Higher Education Opportunity Act

On August 14, 2008, President Bush signed H.R. 4137, the Higher Education Opportunity Act. The Act reauthorizes the Higher Education Act of 1965 for another six years, and includes other provisions intended to improve college affordability, access, and accountability. The Act includes several provisions that may be of interest to students and their families.

Creates a New Website with Comprehensive Information on College Pricing

In an effort to make college costs more transparent to students and their families, the Act directs the Department of Education to create a new user-friendly website that will contain up-to-date information on college pricing, including tuition and fees for the current year, average price after grant aid, recent price increases and changes in per-student spending, among other items. This list will include information for all colleges in the country. The website will also include calculators that students can use to get an early estimate of their expected college costs based on income and family situations, and to estimate the annual and total cost at a particular college.

Encourages Colleges to Rein in Price Increases

The Act directs the Department of Education to publish annually the top 5 percent most expensive colleges in the country, the bottom 10 percent least expensive colleges in the country, and the top 5 percent of colleges with the largest percentage increase in tuition prices over the

previous three years. The schools in the last category must then report the reasons for these price increases to the Department of Education.

Simplifies the Federal Financial Aid Application Process

In an effort to make the Free Application for Federal Student Aid (FAFSA) application less daunting and encourage more families to apply for federal student aid, the Act directs the Department of Education to streamline the FAFSA over the next five years by reducing the number of questions from the current 100+ questions. The Act also provides a two-page FAFSA-EZ form for low-income students, and simplifies the FAFSA re-application process. Also, a new calculator will allow students and families to receive estimates of their Expected Family Contribution (EFC) in the years before they officially submit the FAFSA.

Makes Textbook Costs More Manageable

To address the rising costs of textbooks and discourage the practice of “bundling,” in which textbook publishers package books with often expensive supplementary materials like DVDs,

CDs or workbooks, the Act requires college textbook publishers to provide colleges with full price information on both bundled textbooks and unbundled alternatives, which information can then be passed on to students. Publishers will

OVERVIEW

The following article covers several provisions of the Higher Education Opportunity Act intended to improve college affordability, access, and accountability that may be of interest to students and their families.

Higher Education Act—continued on page 8



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Higher Education Act—from page 7

also be required to sell unbundled versions of every bundled textbook they sell.

Promotes Student Loan Literacy

The Act requires private student loan lenders to first inform students of their federal borrowing options. The Act also requires that all exit loan counseling be done with the school's involvement, and requires that students be informed of all possible repayment options. In addition, the Act requires colleges to fully disclose all relationships with private student loan lenders, and requires private lenders to prominently disclose all loan terms and conditions to student borrowers.

Expands the Pell Grant and Federal Work-Study Program

In an effort to expand access to college, the Act increases the maximum Pell Grant from \$5,800 to \$9,000 per academic year and, for the first time, makes it available year-round. The Act also expands the community service opportunities under the federal Work-Study program.

Increases College Aid for Veterans and Military Families

The Act creates a new scholarship program for active military duty personnel and family members, including children and the spouses of active duty military service members or veterans.

Expands Loan Forgiveness Programs

To encourage students to enter vital public service jobs, the Act authorizes up to \$10,000 in loan forgiveness for teachers, nurses, law enforcement officers, firefighters, first responders, military service members, public defenders, prosecutors and others serving the public interest.

Improves campus disaster readiness plans

The Act creates a National Center for Campus Safety and helps colleges develop and implement state-of-the-art emergency systems and campus safety plans. ■

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