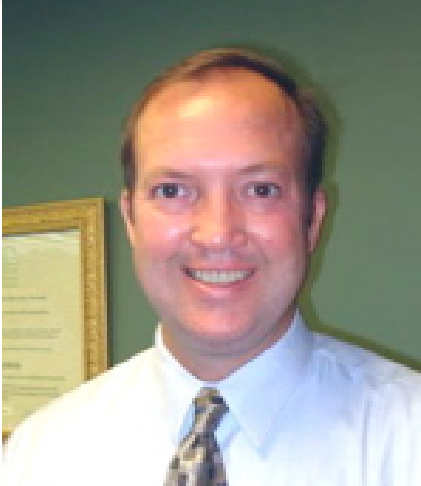
Hampton Roads Dental Financial Planning Newsletter



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IN THIS ISSUE

Great Questions To Ask Your CPA This Summer...

Q&A ROTH IRA Conversion

Investing in a Low Interest Rate Environment

Is Your Insurance Company Safe?

Great Questions To Ask Your CPA This Summer

What Your Hygiene Department Can Teach You About Tax Planning

By Jake Jacklich CFP®

Having just gotten through tax season the last thing that you might want to discuss with your CPA are taxes. Although counterintuitive, *NOW* is the best time of year to address the issue head-on and here's why. It's summer and your CPA has time available to work with you.

Consider the following—as a dentist you know that hygiene treatment and corrective dentistry are different services. They are billed separately. Clinical excellence in both services is essential for a good patient outcome. I'm confident that your office does a good job of communicating and educating your patients about the importance of healthy habits.

Unfortunately, in my experience as a CERTIFIED FINANCIAL PLANNER™ practitioner working with self-employed dentists, I've found that many CPA firms neglect the importance of tax planning. Tax planning is like Hygiene. Tax planning is not income tax preparation. Income tax preparation is more like corrective dentistry. If you only see your CPA in April, your visits are likely painful and expensive. If accountants were dentists you would probably look upon many them in much the same way as you do those doctors who only perform "drill & fill" dentistry. In short, you need to have your CPA teach you how to brush and floss.

The following are a few very good questions to discuss with your CPA. As a self-employed dentist the answers you get will depend on your individual circumstances.

✓If not already done, ask your CPA how you might benefit from the establishment of an "administrative home office" as your principal place of business.

✓Ask your CPA how you might increase the fraction of your deductible business auto expenses.

✓If you operate your practice as a corporation, ask if you are correctly keeping your personal expenses separate from your corporate expenses. Is your practice reimbursing you correctly?

✓Discuss how having family members on the payroll might be beneficial. Ask if you are documenting your family members' employment records correctly.

✓As we get closer to the summer vacation season, ask your CPA about the tax rules for business travel.

✓Ask your CPA for a written professional opinion as to which business entity form would be best for your current situation.

✓Ask your CPA about the deducibility of health insurance and long term care insurance for family members as a business expense.

✓Ask about the tax consequences of replacing that gas-guzzling SUV, which your practice expensed a few years back.

✓If you own your clinic, ask your CPA about a "cost segregation analysis" and if accelerating the depreciation of assets within your office building would be helpful.

✓Are you ready for an IRS audit today? Ask about your business tax record requirements, and what your CPA needs from you.

✓Ask your CPA how a tax qualified retirement plan might benefit you.

✓If you are subject to the Alternative Minimum Tax, ask your CPA how increasing your Schedule C deductions might help.

Ask if there are any other things, which you could be doing to save, minimize or defer taxes this year. Every dollar you save in taxes is a dollar that could be growing in an investment to achieve your goals.

As a CFP® practitioner I know the basics about income tax planning—I can recognize red flags. With the exception of a retirement plan, I can't directly evaluate or implement income tax planning strategies. Your CPA is the tax advisor and a vital team member—he or she must do more than prepare your return. Your CPA must lead and implement income tax strategy.

Waddell & Reed does not provide tax advice, please consult your tax advisor prior to making financial related decisions.

Q&A

Can I convert my traditional IRA to a Roth in 2009?

With recent market declines, many investors are taking a new look at converting their traditional IRA to a Roth IRA. For many, the tax cost of converting has dropped significantly, making this a more attractive option.

You can convert your traditional IRA to a Roth IRA in 2009 if your modified adjusted gross income (MAGI) is $100,000 or less. If you file a joint federal tax return with your spouse, the $100,000 limit applies to your combined income. If you're married filing separately, you're not allowed to convert at all in 2009.

You generally have to include the amount you convert in your gross income for the year of conversion, but any nondeductible contributions you've made to your traditional IRA won't be taxed.

If you're not eligible to convert in 2009, there's always next year--literally, in this case. Starting in 2010 anyone can convert, regardless of income level or marital status. Plus, if you convert in 2010, you're allowed to spread the income tax hit over two years: you report half the taxable income from the conversion in 2011, and half in 2012. So, even if you're eligible to convert in 2009, you should discuss with your financial professional whether it makes sense in your particular case to wait until 2010 to convert in order to take advantage of this special tax rule.

If you're eligible, converting is easy. Simply notify your IRA provider that you want to convert your existing IRA to a Roth IRA, and they'll provide you with the necessary paperwork to complete. You can also transfer or roll your assets over to a new IRA provider. Remember that you can also convert SEP IRAs (and SIMPLE IRAs that are at least two years old) to Roth IRAs. And, if you're eligible for a distribution from your employer retirement plan (for example, a 401(k) or 403(b) plan), you may also be eligible to transfer or roll over those distributions to a Roth IRA, subject to these same conversion rules.

I converted my traditional IRA to a Roth in 2008--can I undo this?

In most cases, yes. If you converted your traditional IRA to a Roth IRA in 2008, before the recent market downturn, you may find that you now owe taxes on a conversion amount that's significantly higher than what your investments are now worth. If that's the case, you may find it advantageous to undo your conversion. The IRS refers to this process as a "recharacterization."

You may also want to recharacterize if you converted in 2008, and now find that you weren't eligible because your 2008 income is higher than you expected.

A recharacterization is essentially a do-over. You're treated as if you never converted your traditional IRA to the Roth IRA. You accomplish this by transferring the Roth IRA assets, and any earnings, back to a traditional IRA (in a trustee-to-trustee transfer if you're using a new traditional IRA provider).

To undo your 2008 conversion, you need to carefully follow these steps:

• Inform your IRA providers (the one holding the Roth IRA and the one providing the traditional IRA, if different) that you intend to recharacterize your Roth IRA to a traditional IRA. You must provide this notice on or before the date the assets are transferred back to the traditional IRA.

• Make sure the transfer is completed by the due date for filing your federal income tax return for 2008, including extensions. For most taxpayers, that can be as late as October 15, 2009. (If you've already filed a timely 2008 tax return, you can still recharacterize by making the transfer and filing an amended return by October 15, 2009. Be sure to write: "Filed pursuant to Section 301.9100-2" on your Form 1040-X.)

• Report the recharacterization to the IRS (see Form 8606 for more information). If you undo your 2008 conversion in 2009, you generally won't be able to convert back to a Roth IRA until 31 days after the recharacterization.

Investing in a Low Interest Rate Environment

Low interest rates create a dilemma. Do you accept a low return because you feel you must protect your principal? Or do you take on greater investment risk in order to try for a higher return? In balancing those two concerns, here are some factors to think about.

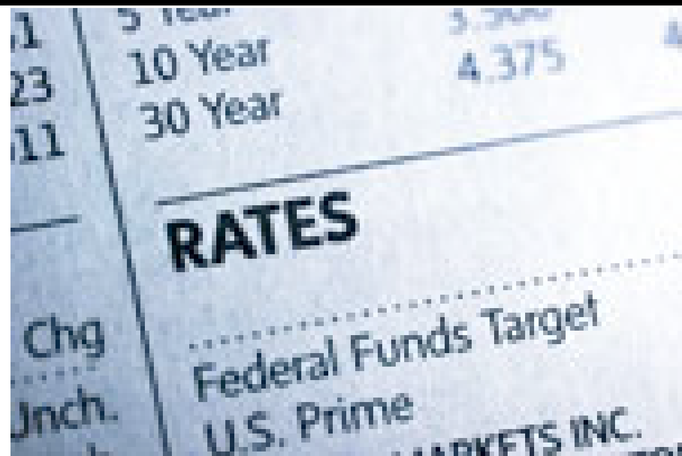
Consider laddering your CDs When yields on Treasury bonds began dropping last year, many investors were attracted to certificates of deposit (CDs) offered by banks that needed to attract capital. However, interest rates won't stay low forever, and at some point you may want access to your money before a CD matures. One way to achieve higher rates while retaining flexibility to adjust your strategy over time is to ladder CDs. Laddering involves investing in CDs with varying maturity dates. As the shorter-term CDs mature, you can reinvest in one with a longer term and higher rate. Over time, laddering can give you both the higher rates typically offered by longer-term CDs and the ability to adjust as interest rates change.

Example: *Susan wants to invest $60,000 in CDs. She puts $20,000 in a six-month CD that pays 2.6%, another $20,000 in a three-year CD that pays 3%, and the final $20,000 in a five-year CD that pays 3.5%. When the six-month CD matures, she reinvests that money in another five-year CD. When her two-year CD matures, she reinvests it in still another five-year CD. At that point, funds from a maturing CD will be available roughly every other year, but will earn the higher five-year rate. If rates are lower when a CD matures, she has the option of investing elsewhere. (This is a hypothetical example and doesn't represent the results of any specific investment.)*

DON'T STOP AT YIELD

IF YOU'RE TEMPTED TO SEEK A HIGHER RETURN, DON'T FORGET THAT YIELD ALONE SHOULDN'T BE YOUR ONLY CRITERION. IN REACHING FOR ADDITIONAL YIELD, YOU MAY BE TAKING ON ADDITIONAL RISK. ALSO, IF AND WHEN INTEREST RATES RISE, THE CHANGE MAY AFFECT A BONDS MARKET VALUE UNLESS HELD TO MATURITY. DON'T HESITATE TO GET EXPERT HELP TO ASSESS WHETHER YOU CAN INCREASE YOUR RETURN WITHOUT TAKING ON MORE RISK THAN YOU CAN AFFORD.

Pay attention to expenses Low returns magnify the impact of high investing expenses. Let's say a mutual fund has an expense ratio of 1.00, meaning that 1% of its net asset value each year is used to pay operating expenses such as management and marketing fees. That 1% represents a bigger relative bite out of your return when the fund is earning 3% than it does if it's earning 10%. At the higher number, you're losing only about 10% of your return; at 3%, almost a third of your return goes to expenses. Before investing in a mutual fund, carefully consider its fees and expenses as well as its investment objective and risks,



which can be found in the prospectus available from the fund. Read the prospectus carefully before investing. If you prefer individual stocks, keep an eye on trading costs.

Think about your real return Low interest rates may not be quite as problematic as they seem. Even if you're earning a low interest rate, your real return might not suffer too much if inflation is also low. Real return represents what your money earns once the impact of inflation is taken into account. With an annual inflation rate of 0.1%--the December 2008 Consumer Price Index (CPI) figure--a bond that pays 3% would produce the same real return as a bond that pays 5% when annual inflation is running at 2.1%.

Compare interest rate and yield spreads When market instability drove many investors to the safety of Treasury bonds, their prices rose and yields fell. As a result, the spreads between Treasury yields and those of corporates and municipals have been relatively high over the last year because non-Treasury bonds have to offer higher yields to compensate for investors' anxiety about the safety of their principal and possibility of default.

Consider small changes You may not need to remake your portfolio completely to seek a higher return. For example, if you're in Treasuries, you could move part of that money to municipal bonds, which may involve greater risk of default but whose net returns are boosted by their exemption from federal income tax. Or you could shift a portion of your stock allocation to dividend-oriented stocks and ETFs, or preferred stock.

Look for buying or selling opportunities Interest rates also can be used to help evaluate equities. Some analysts like to determine the relative value of the stock market using the so-called Fed market valuation model. (Though not officially endorsed by the Federal Reserve Board, the method evolved based on a 1997 Fed report.) The model compares the earnings yield on the S&P 500 to the 10-year Treasury bond's yield. If the S&P's yield is higher than the T-bond's, the model considers the market undervalued relative to bonds. If the Treasury yield is higher, the market is overvalued. However, this is only one of many valuation models and shouldn't be the sole factor in your decision.

Is Your Insurance Company Safe?

The recent financial difficulties of some of the largest and oldest insurance companies may have you wondering about the financial strength of your insurer. Here are some sources of information that you can use to help you determine whether your insurance policy is safe.

It's in the ratings There are several rating services that review, evaluate, and rank insurance companies based on their financial strength and claims-paying ability. The primary players in the ratings game are A.M. Best (www.ambest.com), Standard & Poor's (www.standardandpoors.com), Fitch (www.fitchratings.com), Moody's (www.moodys.com), and The Street.Com (formerly Weiss, www.thestreet.com).

The standards used by each ratings service differ, and the ratings ultimately reflect the service's opinion of the financial strength and claims-paying ability of the insurer--it is not a guarantee of future performance. So you should consider your insurer's ratings from at least two or more services to determine its financial strength.

State regulation Insurance companies are heavily regulated by the states in which they are headquartered.

Generally, each state requires that an insurer has sufficient reserves to pay all of its claims. In addition, states require that companies file updated financial reports that often are available to the public through the state's insurance department. Check with your state's department of insurance for information about the company maintaining your policy.

Important financial information While financial ratings are important, there are other sources that provide financial information about your insurer. For instance, the National Association of Insurance Commissioners (NAIC) is an organization representing the insurance departments of all 50 states. You can access their information by going to www.naic.org. An important statistic contained in the NAIC's financial report of each company is the assets to liabilities ratio. This statistic compares the insurer's total assets to its total liabilities. For example, a favorable assets to liabilities ratio may be $108 of assets for each $100 of liabilities.

Comparing companies Many insurers subscribe to the Standard Analytical Service, Inc., an independent organization that compares insurance companies based on financial statements filed with state departments of insurance. Many insurers publish the Standard's reports on their websites.

The reports compare insurers based on a few important statistics. One such statistic compares the ratio of an insurer's bonds, stocks, cash, and short-term investments to liabilities. A higher ratio of liquid assets to liabilities may indicate the company's ability to cover unforeseen emergency cash requirements if they arise.

Another statistic compares an insurer's surplus assets to life insurance in force. A high ratio of surplus to life insurance in force provides evidence of a company's ability to meet its claims obligations.

If you claim benefits from your policy during a period of extraordinary claims activity, will your insurer be able to satisfy your claim? The chances are better if the insurer has a high ratio of assets, including capital, to policy reserve liabilities. A high surplus ratio may indicate a company's ability to meet its claims obligations even during a period of high volume.

If the worst happens ... If your company experiences severe financial difficulties, it might be taken over by the state's insurance department. Generally, claims continue to be honored as long as premiums are current. If the company lacks sufficient assets and reserves to pay all claims, the state's guaranty association will either pay claims directly or transfer the policies to a financially stable insurance company that will honor the claims. The National Organization of Life and Health Insurance Guaranty Association (NOLHGA) provides information on state guaranty associations and insurance companies that have failed or are in danger of failing (www.nolhga.com).

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The accompanying articles:

- Can I covert my traditional IRA to a Roth in 2009?
- I converted my traditional IRA to a Roth in 2008-can I undo this?
- Investing in a Low Interest Rate Environment
- Is Your Insurance Company Safe?

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