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MARCH 2010



WHAT'S NEW IN 2010

From the homebuyer's credit to the estate tax's repeal, 2010 has brought with it several changes that could impact your tax planning in the year ahead. As you seek to maximize your tax-savings, keep these important changes in mind.

ROTH IRA CONVERSIONS. Previously, individuals with incomes above \$100,000 were unable to convert their traditional IRAs to Roth IRAs. In 2010, Congress has given taxpayers, regardless of their income, the option to undertake a Roth IRA conversion. You will still have to pay income tax on the money you convert, but you have the option of spreading the tax payment over 2011 and 2012. Before you decide to take the leap, however, compare your expected long-term tax rate to your present tax rate to ensure a Roth IRA conversion is right for you. Also, consider if you have the means to pay any required tax with proceeds outside of the converted Roth account. While you are able to pay the taxes with proceeds from the account, doing so greatly reduces the benefit of the conversion in the first place.

ESTATE TAX AND GENERATION-SKIPPING TRANSFER TAX. As we have discussed in greater detail in a stand-alone article on the subject, Congress' inaction in passing new estate tax legislation has resulted in the repeal of the estate tax for 2010. This means there is no tax liability associated with passing wealth on to heirs this year. Previously, estates valued over \$3.5 million would have been subject to a 45% federal estate tax. This victory is short-lived, however. In 2011, the estate tax will be back with vigor. As it stands, tax rates will increase to 55% and estate exemption amounts will decline from \$3.5 million to \$1 million. An often overlooked aspect of the estate tax repeal is the manner in which cost basis will transfer to heirs. In previous years, cost basis was "stepped up" to the asset's current value at either the deceased's time of death or the value six months later. Now, basis is to be carried over. A limited step-up will be allowed for the first \$1.3 million transferred to non-spousal heirs and \$4.3 million transferred to spouses. These new estate tax rules present some near term planning opportunities, but consult with your planner before making any changes to your estate plan. Congress has indicated it may pass an estate tax this year and make the new law retroactive to Jan. 1, 2010.

With the evolving tax laws, it's increasingly important to stay up to date on how these changes could impact your tax and estate planning needs. If you're uncertain how these new rules could impact you, give us a call. We have the tools and expertise to meet your planning needs.

Also in this issue...

Market Commentary

Exit Planning

Retirement Planning for
Closely Held Businesses

Tax Calendar

MARKET COMMENTARY

After finishing 2009 up +23.5%, the S&P 500 slipped -3.70% in January as investors turned their concerns towards global economic growth in a post-stimulus world. The decline came in spite of a strong 5.7% annualized GDP growth rate in the fourth quarter and a flurry of reports showing improving economic fundamentals. Still, the uncertainty surrounding a post-stimulus economy has investors worried that businesses and consumers are ill-equipped to take over as the leading economic drivers.

Looking back, the markets have rallied nearly 60% since last year's lows. This, in large part, has been a reaction to not only the stimulus' direct economic impact but also the rebound in confidence due to the government backstop. As economic growth transitions from the public sector back to the private sector, it is understandable why the market would express some apprehension in how smoothly this transition might take place. Although economic data may continue to be volatile, the indication is that we are still firmly pointed towards recovery -- albeit at a slow and measured pace.

Economic reports in the fourth quarter confirmed an improving business landscape. GDP posted its second consecutive quarter of growth which, by technical definition, means the recession has ended. Aiding GDP growth were inventories, consumer spending, and exports. Rising inventories contributed 3.4% to the overall GDP growth, suggesting that businesses are growing more confident in their ability to move goods. Inventory restocking should continue as consumer spending, which was up 2% in the quarter, continues to improve. In the manufacturing and service sectors, expansion continued with the ISM Manufacturing and Nonmanufacturing indices reading 58.4% and 50.5% in January.

As the markets look to the months ahead, risks remain that could lead to some volatility.

(continued on page 3)

GET READY TO EXIT

For many business owners, planning for the eventual exit from their business takes a backseat to day-to-day operations. It typically isn't until they decide to exit the business that they consider working with an exit planner. Without a well-designed exit strategy, business owners put one of their largest personal assets at risk, often incurring unnecessary taxes and accepting below-market offers for their company. Don't fall victim to this trap, start planning today so you can receive top dollar for your business tomorrow.

“Without a well-designed exit strategy, business owners put one of their largest personal assets at risk”

Before starting your exit planning it's important to understand your personal circumstance by developing a comprehensive financial plan. A comprehensive financial plan not only allows you to assess your current financial situation, but it also helps identify your personal goals for when you leave your business. This is a critical first step, helping assure that the strategy developed for your exit plan ultimately coordinates back to your personal needs.

After developing a comprehensive financial plan, an exit strategy is designed that identifies and organizes owner-driven requirements. Working with an exit planner gives you the best opportunity to quantify, prioritize, and, if necessary, modify your firm's key value drivers to assure you receive the best price for your firm. Furthermore, a planner should provide you with the appropriate strategies to extract this value when you do ultimately choose to leave your business. In addition to simply optimizing your business assets for the eventual transition, a good planner will assist in developing the proper incentive structures, management agreements and benefits packages that are so critical in assuring your top staff remains committed to your organization throughout

the transition.

Generally speaking, most small business owners exit their business through a sale to either an internal or external buyer. An internal buyer might be a junior partner or family member, who, typically, has worked in the company. Most owners prefer an insider sale due to the ease and familiarity of having worked with the buyer. Often times, however, internal buyers require seller financing, which can be an important consideration in the context of the business owner's personal financial plan. At the other end of the spectrum is an external sale. While an external sale may result in a greater, initial cash payment, the business owner is often required to stay engaged with the firm for some period of time after closing. Furthermore, an external sale may be subject to staged liquidity

events making the ultimate final sales price somewhat uncertain. All exit methods present both pros and cons. An exit planner will sort through the competing caveats and goals to help you structure a deal that maximizes your opportunity.

Exit planning is becoming an increasingly important discipline as the baby boomer generation prepares for retirement. In the coming years, more and more businesses will hit the market and you need to be sure that your business stands apart in this increasingly competitive environment. Our team of financial planners, accountants, and management consultants can help you navigate the terrain and develop an integrated strategy for meeting your retirement needs.



RETIREMENT PLANS FOR CLOSELY HELD BUSINESSES

There are many options available to closely-held business owners in order to plan for their and their employees' retirement. Those planning options fall into two broad categories, *qualified* and *non-qualified* plans. A qualified plan is granted special tax benefits, but, generally, must be made available to all employees who have met certain age and employment criteria. A non-qualified plan receives no special tax benefits, but may be made available to one or more selected employees. In this article we will focus on *qualified* plan options.

The tax incentives for establishing a qualified plan are tremendous. First, dollars that are contributed by the employer to a qualified retirement plan are tax deductible to the company. And, even though the money may be placed into an account for the benefit of its employees, the money is not currently taxable to the participants in the plan. Plan assets may be invested in a broad range of investments, yet all of the income and/or gain generated by those investments is sheltered from current tax until each employee retires. Then, the retired employee is only taxed on that portion which he/she withdraws, leaving the remaining portion to continue growing, sheltered from tax.

Qualified retirement plans for closely held businesses are typically either defined *benefit* plans or defined *contribution* plans. Up until the mid eighties, retirement planning focused more on defined benefit plans, but recently, these types of plans have begun to stage a comeback. Simply put, in a Defined Benefit Plan (frequently called a Pension Plan), the employer promises to pay a stated retirement income to employees as each employee reaches retirement age (usually age 65). The retirement benefit may be specified as a percentage of pay or a dollar amount. Whatever the retirement formula is, the employer must make mandatory and potentially variable contributions each year in order to accumulate enough proceeds to sustain the promised benefit as each employee reaches retirement age. This form of plan is most attrac-

tive to businesses that are making a lot of taxable profits and whose key, highly compensated employee(s) is older than most other workers in the company. This is because the contribution required to meet the older, higher paid employee's funding ob-



jective is much higher than younger, lower paid workers. This is true simply because the employer has less time to accumulate the funds necessary to fund the stated benefit for the older employee. Even though the contribution mix may be highly weighted to the older, higher-paid employee, the contributions are still fully tax deductible!

Virtually all other retirement plans fall under the defined contribution plan category. These plans are intended to do precisely what their name implies. The company pays a set contribution, usually based upon a percentage of the employees salary or as a match to the employees own contribution. Below are some popular styles of defined contribution plans with a brief review of their most prominent features.

PROFIT SHARING PLANS are established by an employer for the purpose of making proportionate contributions to eligible employees based on the profitability of the firm. Profit sharing plans may have a vesting

(continued on page 4)

("Market Commentary" continued)

As we've already mentioned, first on the list is the abatement of the stimulus and concerns related to a proverbial "double dip." Second, top-line growth could remain anemic which would most certainly disappoint the market based on the current expectation baked into its current valuation. Third, the massive increase in domestic and international governmental debt could weigh on global growth as nations wrestle with servicing debt loads amidst a less than robust recovery. Fourth, legislative risks related to reforms in the healthcare and financial sectors have exasperated an already uncertain operating environment. Finally, and most importantly, the economy must begin adding jobs.

Despite some of these uncertainties, we think the needle still points toward continued recovery and that investors should continue to maintain an equity bias within the context of their long-term, risk-appropriate asset allocation. Helping support this is the fact that the market tends to post better than average equity returns for two to three years following a bottom. If we look at it from a fundamental earnings basis, we see evidence supporting this technical observation. Standard & Poors estimates that the earnings for the S&P 500 will grow 15.8% in 2010 and 18.6% in 2011. Assuming that PE multiples remain relatively stable and the earnings estimates are met, a 10-20% gain would not be unreasonable. As the growth rate tapers, however, we think the markets will once again place a premium on stable, well-capitalized companies that pay dividends and for that reason we think a tilt toward value within the equity allocation remains warranted. On the fixed income side of things, we simply don't think investors are being compensated appropriately at current yields. While inflation will likely remain under control for the next few years due to the amount of unemployment and excess capacity in the economy, the risk-return ratio just doesn't make sense. For this reason we are encouraging investors to keep their fixed income on the shorter side of the yield curve in hopes of trading up if and/or when rates return to their norms.

("Retirement Plans" continued)

schedule, and may adjust contributions for more highly paid employees to offset the employer's required contributions to Social Security. Company contributions may vary on a year-to-year basis, ranging from no contribution at all up to 25% of total covered payroll.

SIMPLIFIED EMPLOYEE PENSION PLANS (SEP) are very similar to Profit Sharing Plans, but with much less administration and reporting. They have the same contribution limits; however, they have a much stricter plan design, eligibility, and vesting rules. All employees who are at least 21 years old and have been employed for three years must be included. In a SEP plan each participant owns his/her account, thus they are immediately vested. SEPs tend to be very popular with single employee and family employed businesses.

401(k) PLANS have become popular over the last 20 years due to business owners' desire to provide benefits only to those employees who value them. 401(k) Plans give employees the option of whether or not to save for their retirement by allowing them to make pre-tax contributions to a plan. The employer may choose to make matching contributions in order to encourage and supplement employee participation, or the employer may make discretionary profit sharing contributions. Employees are always fully vested on their own contributions, but employer contributions can be subject to a vesting schedule. Under new rules, a company may offer what is known as a "Roth Option" in their 401(k) plan. This enables employees to choose for their contributions to be made on a post-tax basis, but all of the gains and/or earnings to be tax free upon withdrawal after age 59 1/2.

SIMPLE PLANS are in essence 401(k) plans with virtually no reporting or testing re-

quirements. They are cheap to operate, but design and participation eligibility rules are rigid. In a SIMPLE Plan, the employer must either match employee contributions dollar for dollar up to 3% of compensation, or make a non-elective 2% contribution for all employees, whether or not they choose to contribute. Employees are always 100% vested in all contributions, including the employer's. Just as with a 401(k), the employee may make a "Roth Election" for SIMPLE Plan contributions, as well.

EMPLOYEE STOCK OWNERSHIP PLANS (ESOP) are basically Profit Sharing Plans, but with two major differences. First, an ESOP, unlike a plain Profit Sharing Plan, may buy the stock of the sponsoring company. In other words, a company may set up an ESOP, issue stock from its treasury, and use that stock to make tax deductible contributions to the plan. It may also repurchase stock using tax deductible contributions to the plan. These features make ESOPs an important business transition tool.

There are a few other types of retirement plans such as Money Purchase Pension, Cash Balance and Target Benefit Plans; however, these have such limited application that we will save these for a possible discussion about your company's individual planning needs. This article is not intended to give you a complete education on qualified plans, but to give you some ideas on how various plans can be used to attract top talent, create tax savings, and serve as a valuable business planning mechanism to you and your business. If you have any questions or simply need a review of your plan, feel free to give us a call and let one of our financial planners optimize a retirement solution for your closely-held business.

Buddy Ozanne
President, Probity Advisors, Inc.®

TAX CALENDAR AND CONTRIBUTION LIMITS 2010

FEBRUARY 2ND

- You should have received your W-2, 1098 and 1099 forms by now. If you are missing any you should start contacting the issuer.

APRIL 15TH

- Tax returns due.
- If you are filing for an extension, today is your last day to file Form 4868. To avoid any penalties, make sure you have paid any tax that is due.
- Last day to make 2008 contributions to your IRA or Roth IRA.

OCTOBER 15TH

- Tax returns due if you filed for an extension.

RETIREMENT PLAN CONTRIBUTION LIMITS

DBP

No more than 100% of the average of his/her highest three years of earnings with the company or \$195,000, whichever is less.

401(k)

\$16,500 or \$22,000 for those 50 or over.

PSP

Not to exceed the lesser of 100% of an employee's pay or \$49,000.

SIMPLE

\$11,500 or \$14,000 for those 50 or over

IRA

\$5,000 or \$6,000 for those 50 or over.

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