BRIAN D. LOWDER, INC.

QUARTERLY NEWSLETTER

Volume 9, Issue 3 October 2006

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FINANCIAL MARKET OVERVIEW

The unpredictable nature of the financial markets surprised us again during the third quarter. During July, the outlook seemed bleak. We had just finished a disappointing second quarter, conflict in the Middle East erupted and the price of crude oil skyrocketed to over $70 per barrel. By the end of the third quarter, the Israeli/Hezbollah conflict subsided, the Federal Reserve Board stopped raising interest rates and oil prices had dropped to $60 per barrel. Within the past 60 days, a stock rally proceeded with earnest and nearly reached record levels for the year.

It is astonishing to see how quickly investors' moods change, consensus beliefs swing from one extreme to the other and how momentary changes and fluctuations in a few indicators lead the masses in the opposite direction. It seems the new theme in the financial media is that *weakening economic growth* and falling housing prices are good news under the assumption that such developments will ultimately prompt the Federal Reserve to *lower* borrowing costs. Historically, lower interest rates precede stock market rallies.

The Dow Jones Industrial Average and the Standard & Poor's 500 index rose over 5% during the third quarter while the overall stock market was up nearly 4%. The larger and more conservative companies (value stocks) performed significantly better than large growth-oriented stocks, mid-size companies and small-company stocks. International and emerging company stocks rebounded strongly during the third quarter.

We expect more of the same volatility in both directions from the financial markets over the next year. However, over a 12-month period, we continue to expect single-digit stock returns. For the moment, inflationary pressures are generally perceived to have relaxed and economic growth clearly will continue to slow. Consequently, the fear of rising interest rates has subsided and after adding lower energy costs to the picture, the new focus is where it should be – consumer spending and lower economic growth.

Below are sample returns of various asset categories during the third quarter and for the year-to-date ending September 30, 2006:

3rd Quarter	Year-To-Date 2006	(includes dividends reinvested)
+ 5.35%	+ 9.0%	**Dow Jones Industrial Average**
+ 5.67%	+ 7.0%	**Standard & Poor's 500 Index**
+ 4.31%	+ 8.0%	**DJ Wilshire 5000(Broad Market)**
+ 2.56%	+ 0.2%	**Large-company stock-Growth**
+ 5.37%	+ 10.2%	**Large-company stock-Value**
(1.17%)	+ 1.7%	**Mid-Size Stocks – Growth**
+ 2.02%	+ 6.9%	**Mid-Size Stocks – Value**
(2.74%)	+ 1.9%	**Small-company stock- Growth**
+ 0.16%	+ 7.4%	**Small-company stock- Value**
+ 6.10%	+ 14.0%	**International (excludes U.S.)**
+ 5.27%	+ 12.5%	**Emerging Markets**
+ 8.35%	+ 22.1%	**Real Estate Investment Trusts**
+ 2.11%	+ 2.0 %	**Short-term U.S. Treasury** ***(includes appreciation)***
+ 3.22%	+ 3.4%	**Intermediate U.S. Treasury** ***(includes appreciation)***

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The uncertainties surrounding the true economic health of our economy and how the continuing reduction in home prices will impact consumers' willingness to keep spending are the biggest unknowns. Because of the mixed economic signals and unpredictable nature of consensus beliefs, we will continue to maintain a more conservative posture compared to the previous 5 years. As always, we will continue to monitor and review the economic environment as new information becomes available. We encourage your questions or comments and look forward to meeting with you for a more detailed discussion.

PENSION PROTECTION ACT OF 2006

Our previous newsletter identified and explained several of the most practical changes to our tax code as a result of President Bush signing the *Tax Increase Prevention and Reconciliation Act* which became effective August 17, 2006. One of the topics mentioned, the Roth IRA, warrants further discussion. Two other important tax planning opportunities that apply to fewer taxpayers but can have significant income tax and charitable giving benefits are; direct charitable gifting from an IRA to a charity in 2006 and 2007, and non-spouse beneficiaries are now allowed to rollover funds from a qualified retirement plan to an Inherited IRA (formerly only surviving spouses were able to rollover employer-provided retirement plan assets to an IRA).

<u>Tax-Free Distributions from IRAs To Charity</u>
This provision is only effective for tax years 2006 and 2007 and for individuals age 70 ½ and older. ***The tax code has been amended to permit a person to make charitable gifts <u>directly</u> from an Individual Retirement Account (IRA) of up to $100,000 per year.*** The IRA owner will benefit by not having to report the IRA distribution as taxable income. However the donor will not be able to claim a charitable income tax deduction for making the gift. Why is this change important and what are the opportunities?

1. Taxpayers age 70 ½ or older with large IRA balances and charitable goals can make charitable contributions of up to $100,000 directly from their IRA without increasing their taxable income. Prior laws required taxpayers to take a taxable IRA distribution first, make a charitable donation and then discover whether the charitable deduction would fully offset the increase in income taxes.

Charitable deductions cannot exceed 50% of a taxpayer's adjusted gross income (30% limitation for a private charity). A donor who is subject to this annual deduction limitation and who uses a *taxable* distribution from an IRA account to make an additional charitable gift would generally be able to deduct only 50% of the amount donated in the year of the gift.

2. Donors lose tax deductions as their adjusted gross income increases. Married taxpayers with adjusted gross incomes over $150,500 begin losing a portion of their itemized deductions and personal exemptions. As high-income taxpayers withdraw their IRA funds, this will cause an increase in reported income. In addition, their itemized deductions and personal exemptions will be phased-out and/or reduced. In addition, the increase in taxable income (from the IRA distribution) may cause Social Security benefits to become taxable and other deductions (such as medical expenses) are reduced as reported income increases. Donating directly from an IRA account to an eligible charity avoids the above problems.

3. Eligible IRA owners can use charitable gifts directly from their IRAs to satisfy their annual required minimum distribution requirement. All taxpayers age 70 ½ and older are *required* to begin taking taxable distributions from their IRAs. Donating an amount equal to a taxpayer's required minimum distribution directly from the IRA to an

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eligible charity benefits the taxpayer by not having to report the IRA distribution as taxable income.

Technical requirements:

a) Donor must be at least age 70 ½.
b) Qualified charitable distributions may not exceed $100,000 in the aggregate.
c) The provision applies to calendar years 2006 and 2007 only.
d) Charitable contribution must be from an IRA – not a qualified retirement plan (pension, 401(k), profit sharing plan, 403(b), SEP-IRAs etc.).
e) The check or gift payment must come *directly* from the IRA to the charity. If the check is paid to the IRA owner who then endorses the check to the charity, it must be reported as a taxable distribution to the IRA owner.
f) Only outright gifts are eligible. Gift annuities, charitable remainder trusts, donor advised funds, etc. are not eligible.
g) The (gift) payment would normally *fully* qualify for a charitable income tax deduction. This means the entire (gift) payment must qualify as a charitable contribution and thus eliminates distributions used for auctions, raffle tickets, fund-raising dinners, etc.

Who is most likely to benefit?

- Individuals who take mandatory minimum required IRA distributions, but don't need additional income.
- Individuals who wish to give more than the deductibility ceiling (50% of adjusted gross income).
- Individuals with higher reported incomes who are already subject to reduced itemized deductions and personal exemptions.
- Individuals whose major assets reside in their IRAs and who wish to make a charitable gift during their lifetime.
- Individuals who intend to leave all or part of their IRA balances to charity at death.

Below are a few examples of how direct charitable contributions from an IRA can benefit a taxpayer under the new rules:

Example #1: Mr. and Mrs. Smith, ages 73, wish to donate to a private charity and expect to report taxable income of approximately $60,000 in 2006 The Smiths do not itemize their deductions. A $60,000 taxable income would place this couple at the top range of the 15% federal tax bracket. They also must withdraw his Required Minimum IRA Distribution (RMD) of $10,000 (which they typically don't need for living expenses). The federal tax due on the required IRA distribution would place the Smiths' in the 25% marginal tax bracket since their income now exceeds the 15% tax bracket. Therefore, if Mr. Smith personally receives the withdrawal from his IRA, the couple will incur an additional $2,500 federal tax (25% tax bracket x $10,000). Instead of taking the IRA distribution directly in his name and incurring an additional $10,000 of reported income and then making a charitable donation, Mr. Smith could instruct his IRA custodian to make the $10,000 distribution directly to a charity. In this manner, the Smiths accomplish their charitable objective, the $10,000 IRA distribution is not subject to income taxes and their marginal federal tax bracket remains at 15%. The result is a tax-free donation to a private charity.

Example #2: Mr. and Mrs. Jones expect their 2006 adjusted gross income will be over $150,000 and they wish to donate $100,000 to their favorite charity. However, their accountant advises them that a large charitable gift would limit the size of their allowable charitable deduction. If their adjusted gross income exceeds $150,000, the allowable charitable deduction would be limited to 30% for a private charity (30% times $150,000 = $45,000) or 50% for a public charity (50% times $150,000 = $75,000). Under the new law, the Jones could direct their IRA custodian to send an equivalent amount directly from their IRA account. The $100,000 IRA distribution would not be reported as taxable income and the

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charitable deduction limitations would not apply since the gift was made directly from the IRA to the charity. Donating directly from the IRA to a charity would accomplish two important things; first, it results in a tax savings ranging from $7,000 to $15,000 depending on whether the charity is public or private and second, it allows more money to flow to a charity of their choice.

Example #3: Jane Doe receives a pension of $15,000, Social Security benefits of $10,000 and she is required to take a $9,000 RMD from her IRA. Under current tax law, she must include 85% of her Social Security benefits as taxable income which totals $32,500. However, if she elected to donate the $9,000 RMD (IRA distribution) *directly* to charity, she could lower her taxable income and thereby lower the amount of her Social Security Benefits that are subject to income taxes. The end result is a tax savings of more than 50% of the normal tax due.

The above examples are only a few of many possible income tax saving scenarios. This opportunity is only available for a short period of time – three months remaining in 2006 and the entire 2007 calendar year. The opportunity expires December 31, 2007.

<u>Non-spouse Beneficiaries Can Now Rollover An Inherited Qualified Retirement Plan To An Inherited IRA</u>

A non-spouse beneficiary will now be allowed to rollover (transfer) a decedent's qualified retirement plan distribution to his or her IRA *beginning with distributions made after December 31, 2006*. Under present law, only a ***surviving spouse*** was allowed to rollover (transfer) a decedent's qualified retirement plan balance (examples include a pension, 401(k) profit-sharing plan, 401(k), 403(b), etc.) to an IRA.

The advantage of rolling over or transferring the decedent's remaining retirement plan balance to an individual IRA account is to avoid taking a one-time and often large taxable distribution in one lump sum. Transferring the plan balance to an IRA allows the IRA owner (beneficiary) to continue sheltering the lump sum distribution from current income taxation. Once transferred to an inherited IRA, only minimum required distributions based on the IRA owner's remaining life expectancy must be withdrawn in each future calendar year. Extending this rollover or transfer opportunity to non-spouse beneficiaries will significantly reduce the income tax implications upon receiving an inherited retirement plan balance and allow the beneficiary to accumulate greater wealth over his or her life expectancy.

Technical requirements: Transfers must be made directly from the trustee of the retirement plan to the beneficiary's IRA custodian (bank, brokerage firm etc.). If the (inherited) retirement plan balance is made payable directly to the non-spouse beneficiary by check, and the beneficiary deposits the check into a personal or IRA account, the entire sum becomes ineligible for the rollover rules and the entire sum is subject to state and federal income taxes. Distributions must be made via direct trustee-to-trustee transfer, the IRA must be set up as an *inherited* IRA and required minimum distributions must be taken annually over the beneficiary's remaining life expectancy.

Why is this new provision so important? One, it increases portability (the ability to move inherited funds to the beneficiary's preferred financial institution) and has the potential to greatly reduce income taxes on inherited assets. In the past, if a non-spouse was named as the beneficiary of a qualified retirement plan (401k, Profit Sharing Plan, 403b etc.) and the owner died, he or she basically had two options. One, leave the retirement plan balance with the existing plan trustee, accept the limited investment choices offered, and accept the most common pay-out option of annual distributions based on the beneficiary's remaining life expectancy or worse, an equal amount over the next five years. Two,

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request a lump distribution for the total amount and be subject to a potentially enormous income tax liability. With this new provision, the beneficiary will be able to transfer the assets away from the qualified plan and into an Inherited IRA where investment selection is virtually unlimited and taxable withdrawals can be made over a longer life expectancy.

Roth IRA Conversions Available To All Taxpayers

As mentioned in our July 2006 newsletter, one of the practical changes included in the *Tax Increase Prevention and Reconciliation Act* was allowing Roth IRA conversions to all taxpayers regardless of income levels. *Beginning in 2010*, converting regular IRA account balances to a Roth IRA will be allowed for everyone. Presently, only taxpayers with less than $100,000 of adjusted gross income are eligible for a Roth Conversion.

Why convert a traditional IRA to a Roth IRA? Traditional IRA withdrawals during retirement are subject to federal and state income taxes. In addition, the taxpayer MUST begin taking taxable minimum required distributions from a traditional IRA beginning at age 70 ½. On the other hand, future withdrawals from Roth IRAs are NOT subject to income taxes and distributions are not required beginning at age 70 ½ or at any other time. Roth IRA accounts also retain their tax-free status when inherited by beneficiaries. The only drawback to a Roth Conversion is income taxes must be paid in the year converted from a Traditional IRA to a Roth IRA (taxes can be spread over two years for 2010 ROTH conversions only).

A new planning strategy has emerged for high-income taxpayers who cannot make deductible contributions to a regular or traditional IRA. Fully *deductible IRA contributions* are only allowed by taxpayers who are not covered by an employer-provided retirement plan, or if covered, the taxpayer's adjusted gross income must not exceed $75,000 (married) or $50,000 (single).

Between now and 2010, these high-income taxpayers can make contributions to a NON-DEDUCTIBLE IRA. In 2010, the non-deductible IRA can be converted to a ROTH IRA by paying tax only on the growth of the account beyond the contributions made. For example, a taxpayer could make the $4,000 annual contributions ($5,000 if age 50 or older) for each year in 2006 through 2008 and $5,000 for each year in 2009 and 2010) The total amount contributed would be $22,000 over five years. Only the IRA account value above $22,000 in 2010 would be subject to income taxes when converted to a Roth IRA. Once converted, all future withdrawals are not subject to income taxation.

Technical requirements: If a taxpayer makes non-deductible IRA contributions, he or she must file an additional tax form (*Form 8606*) with your federal income tax return each year. Also, by the time 2010 arrives, this opportunity could be closed due to income tax law revisions. However, the worst-case scenario is that you would end up with a non-deductible IRA account and only the growth in the account value above the sum total of contributions made would be subject to income taxes when withdrawn.

CLOSING THOUGHTS

The final days of the 2006 calendar year are rapidly approaching and the holiday season will be upon us before long. We would like to take this opportunity to thank all of our clients and professional advisers for the trust and confidence they have placed upon our

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shoulders. Over the past 20 years of service, we continue to experience the joy of listening, sharing and helping families with their financial concerns and guiding them toward achieving their life goals. Our objective has always been to help you be a wise shepherd over your financial resources and to help you make better financial decisions based upon complete, objective and competent information.

We have much to be thankful for and hope everyone will remember to enjoy the moment, cherish the experiences and be thankful for those relationships that give life its true meaning.

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Best regards

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