



# The Hein Wealth Report

April 2010 Hein Wealth Newsletter

## Hein Wealth & Tax Solutions LLC

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We should be having our open office party in about 6 weeks. We will send out a save the date shortly.

This month's newsletter explains 1) key economic indicators 2) the relative advantages of 529 plans vs. Roth IRAs 3) budgeting and 4) exceptions to the premature distribution tax.

We look forward to seeing you soon.

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Key Economic Indicators and What They Mean

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## Key Economic Indicators and What They Mean

Late last year, members of the Federal Reserve Board's Open Markets Committee (FOMC) outlined some of the indicators they're watching to help determine when the economy might be stable enough to handle higher interest rates. Here's a primer on some of those indicators and why they're important.



*Gross Domestic Product (GDP)* indicates whether the economy is growing, shrinking, or stagnant. It represents the value of all goods and services produced in the United States, minus the value of all imports. This is the broadest measure of economic health.

Inflation represents increases in the cost of goods and services. The *Consumer Price Index (CPI)* represents increased costs for everyday expenditures such as housing, transportation, food, energy, and clothing. In addition to serving as an inflation gauge, CPI affects any payments tied to the cost of living, such as Social Security benefits.

A related measure, so-called core CPI, excludes food and energy prices because they can vary dramatically from month to month. Core CPI is closely watched by the Fed in determining whether and when to raise or lower its target interest rate, which in turn affects bond prices and other interest rates.

Still another inflation yardstick is the *Producer Price Index (PPI)*, which reflects prices at the wholesale level. If prices are rising for items used to manufacture a product, manufacturers and wholesalers may pass increased costs on to retailers and/or consumers. As a result, increases in the PPI can be an indicator of potential future inflation at the consumer level.

*Unemployment and payroll statistics* may seem similar, but they indicate slightly different things. The unemployment percentage usually

quoted in news headlines is based on a Bureau of Labor Statistics (BLS) survey of households. However, it doesn't include people who are working part-time involuntarily, or so-called "discouraged workers" who haven't been able to find a job and have given up looking. The BLS payroll figure uses corporate job records to show whether employers are creating or shedding jobs.

The unemployment rate is traditionally considered a lagging economic indicator, because an increase in jobs typically shows up only after other economic indicators, such as business inventories and unused manufacturing capacity, have begun to show signs of health. However, some economists argue that because the economy has relied heavily for many years on consumer spending, unemployment may now be more of a leading indicator than in the past.

*Personal incomes* as measured by the Commerce Department reflect not only paychecks but corporate and government benefits, pension checks, rental income, dividends, and interest payments; the data can give hints about future spending. *Personal consumption expenditures (PCE)* data show actual consumer spending on goods and services. As with core CPI, the Fed relies on PCE when setting its target interest rate.

*Industrial production* figures indicate whether factories are producing as much as they're capable of. When resource utilization is low, it suggests that factories are unlikely to experience near-term inventory shortages that could spark inflation. Somewhat related are *durable goods orders*, an indicator of inventory level and business investment in equipment. Also of interest are housing starts, new building permits (which hint at future construction), and new and existing home sales and prices.

These are only some of the data points to watch as guideposts in the months ahead.



## 529 College Savings Plans vs. Roth IRAs

According to an article in *The Wall Street Journal* ("More Parents Are Becoming 529 Dropouts," November 11, 2009), after the 2008/09 market collapse, some investors--and financial advisors--have reduced their reliance on 529 plans. Some of this pullback can be attributed in part to a broader retreat from the stock market as a whole. But another part can be attributed to parents who have opted to trade the tax benefits of 529 plans for college savings vehicles that don't have a "must-be-used-for-college" restriction. And as parents seek to save for their own retirement too, one such vehicle is a Roth IRA. So, just how does a favorite of the college savings world, a 529 college savings plan, stack up to a favorite of the retirement savings world, a Roth IRA, as an education-funding vehicle?

### Tax benefits

Both 529 college savings plans and Roth IRAs offer federal tax-free earnings if certain conditions are met (and most states follow this tax treatment), but only 529 plans offer the possibility of a state tax deduction too.

For 529 plans, earnings are tax free at the federal level if the distribution is used to pay the beneficiary's qualified education expenses--a broad term that includes tuition, fees, room and board, books, and computers--at any accredited college in the United States or abroad. If the distribution is used for any other purpose, earnings are subject to income tax and a 10% federal penalty tax.

For Roth IRAs, earnings are tax free at the federal level if the distribution is "qualified." A distribution is qualified if a five-year holding period requirement is met and one of the following conditions is met: (1) you are at least age 59½; or the distribution is made (2) due to a qualifying disability; (3) to pay certain first-time homebuyer expenses; or (4) by your beneficiary after your death.

If you are younger than age 59½ and you have a taxable distribution, you will also pay a premature distribution tax (also called an early withdrawal penalty) equal to 10% of the earnings portion of the distribution. But there are exceptions to this penalty, and one is if the money withdrawn is used to pay your child's qualified higher education expenses.

Bottom line: if you withdraw money before age 59½ to pay your child's college expenses, you'll generally owe income tax on the earnings, but not an early withdrawal penalty. However, you

may not end up owing income tax on the earnings, because Roth IRA distributions generally aren't taxed as earnings until the principal has been fully withdrawn. (By contrast, a distribution from a 529 plan is considered part principal and part earnings.)

### Financial aid

There is an important difference here. Under federal financial aid rules, 529 plans are counted as a parent asset (if the parent is the account owner), and 5.6% of all parent assets are deemed available for college costs. By contrast, the federal aid methodology doesn't count retirement assets in determining aid eligibility. So a Roth IRA won't impact the amount of federal aid your child may be eligible for. However, although Uncle Sam doesn't count retirement assets, colleges typically do when awarding their own institutional aid.

### Investment choices

Roth IRAs have the edge here--you can choose from a wide range of investments to fund your Roth IRA, and you can buy and sell investments whenever you like. But with a 529 plan, you are limited to the investment options offered by the plan. If you're unhappy with the investment performance of the options you've chosen, most plans let you change the investment options for your future contributions at any time, but for existing contributions, you can only change investment options once per year (twice per year in 2009 only). In 2008 and 2009, this restriction proved costly for many 529 account owners: having reached their limit on investment changes for the year, they were unable to make further changes in response to deteriorating market conditions.

### Lump-sum contributions and eligibility

If you have a lump sum to contribute, 529 plans allow individuals to gift up to \$65,000 in 2010 (\$130,000 for married couples) and avoid gift tax if certain conditions are met. By contrast, Roth IRAs have a contribution limit in 2010 of \$5,000 (\$6,000 for individuals age 50 or older). And your ability to contribute to a Roth IRA depends on your income level. But anyone can contribute to a 529 plan--there are no restrictions based on income.

### Bottom line

Whether a Roth IRA or a 529 college savings plan is best for your college savings depends on your personal circumstances and the factors discussed here.

### Note on 529 plans

*Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.*

## Back to Basics: Reviewing Your Budget

Do you ever wonder where your money goes each month? Does it seem like you've gotten sidetracked when it comes to reaching your financial goals? If so, you may want to review and perhaps revise your budget. Doing so can help you determine how you're spending your money, and that might show you what you need to do to get back on track.

"Oh, we don't need a budget," you might be saying. "We have plenty of money." If that's true, great! But if you aren't reaching your financial goals, there's a reason for that. Reviewing (or simply creating) your budget might help you find out what that reason is.

### Examine your financial goals

The first part of reviewing your budget should be an examination of your financial goals. After all, planning any trip's itinerary depends in part on knowing where you want to go! Make a list of both your short-term and your long-term goals, and prioritize them. How much will you need to save for each one, and how long will you have to reach them? Should you forestall some of lower priority to reach others of higher priority?

### Keeping track

Budgeting is largely about tracking your income and expenses. You can do this with a pen and paper, or you can use one of the many software programs or web-based applications designed for this purpose. The most important element of this process is to do it consistently.

Should you count every penny? Not necessarily, although to some extent you can't control the dollars if you don't track the cents. But focus primarily on meeting the basic expenses of life and then allocating what it will take to meet your goals.

### Income and expenses

Much of your income may come from your regular paycheck or (if you're retired) from government benefits such as Social Security, a pension, or retirement account distributions. But don't forget to include all forms of income, such as child support and/or alimony, and even irregular or seasonal income, such as tax refunds, dividends, or interest.

Expenses generally fall into two categories. Fixed expenses are the "have-to" basics: housing, utilities, food, clothing, and transportation. Discretionary expenses are "want-to" items: eating out, entertainment, vacations, and hobbies.

Irregular expenses can't be predicted, but they always occur: car repairs and home maintenance are good examples. Remember to include these types of expenses in your accounting. For example, if you buy tires for your car every 3 years, one-third of the total is your annual expense.

**Caution:** *While you may find it easy to use your credit card for irregular expenses, do so only as a convenience. Be prepared to pay off the credit card charge with funds you have set aside in your budget for these expenses.*

Finally, prioritize the funds you'll need to meet both your short- and long-term goals as regular expenses in your budget.

### And the answer is...

Once you've added up your income and expenses, you'll need to compare the totals. Are you spending exactly what you're making? Congratulations, your budget is perfectly balanced! Even better, if you're spending less than you're making, you have a surplus. If that's the case, you can allocate that surplus to either reaching your goals faster or funding new investment opportunities.

But if you're spending more than you're making, you're running a deficit. You might not feel the pinch if you're very good at juggling or funding it with increasing credit card debt or a home equity line of credit. But even the best of jugglers drop the balls sometimes, and increasing your debt can be dangerous. If that's what you're doing, you're sidetracking your budget into a dead-end spur.

So, to balance your budget and get back on track toward meeting your goals, you'll have to either increase your income or reduce your expenses--or both. As you may have seen while tracking your expenses, it's often your discretionary spending that leads to a derailment when it comes to meeting your goals. Rather than shortchange your goals (you'll only be shortchanging yourself if you do), work on reducing discretionary expenses.

### Staying on track

You'll need to monitor your budget to keep it on track. Remember that, like life itself, you'll need to keep your budget as flexible as your changing circumstances may demand.



*"The first part of reviewing your budget should be an examination of your financial goals. After all, planning any trip's itinerary depends in part on knowing where you want to go!"*





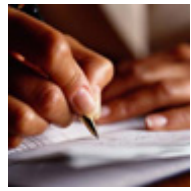
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## Ask the Experts



### What is the premature distribution tax?

Taxable distributions you receive from an IRA, 403(b), 401(k), or qualified employer plan before age 59½ are generally referred to as premature distributions, or early withdrawals.

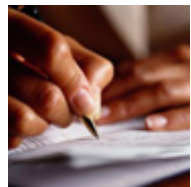
To discourage early withdrawals, they're subject to a 10% federal penalty tax (and possibly a state penalty tax) in addition to any federal and state income taxes. This 10% penalty tax is commonly referred to as the premature distribution tax. Not all distributions before age 59½ are subject to this penalty, however.

Here are the most important exceptions:

- Distributions due to a qualifying disability
- Distributions to your beneficiary after your death
- Distributions up to the amount of your tax-deductible medical expenses
- Distributions made pursuant to a qualified domestic relations order (QDRO)

- Qualified reservist distributions
- Distributions from an IRA (but not an employer plan) to pay first-time homebuyer expenses (up to \$10,000 lifetime)
- Distributions from an IRA (but not an employer plan) to pay qualified higher education expenses
- Distributions from an employer plan (but not an IRA) after separation from service at 55 or older
- Certain distributions from an IRA (but not an employer plan) while you're unemployed up to the amount you paid for health insurance premiums
- Amounts levied by the IRS
- Distributions that qualify as a series of substantially equal periodic payments (SEPPs)

If you must take a distribution from your IRA or employer plan before age 59½, be sure to determine if one of these exceptions applies to you.



### What is the "SEPP" exception to the premature distribution tax?

Taxable distributions you receive from an IRA or 401(k) plan before age 59½ are subject to a 10% early withdrawal penalty unless an exception applies.

One important, but sometimes overlooked, exception is for SEPPs--substantially equal periodic payments.

SEPPs are amounts you withdraw from your IRA or employer plan over your lifetime (or life expectancy) or the joint lives (or joint life expectancy) of you and your beneficiary. To avoid the 10% penalty, you must calculate your lifetime payments using one of three IRS-approved distribution methods and take at least one distribution annually.

You can take advantage of the SEPP exception at any age. But payments from an employer plan must begin *after* you separate from service.

Even though SEPPs are initially determined based on lifetime payments, you can change--or even stop--the payments after five years, or after you reach age 59½, whichever is

later. For example, you could start taking SEPPs from your IRA at age 50, without penalty, and then, if you no longer need the funds, reduce (or stop the payments altogether) once you reach age 59½.

But be careful--if you "modify" the payments before the required waiting period ends, the IRS will apply the 10% penalty tax (plus interest) to all taxable payments you received before age 59½ (unless the modification was due to death or disability).

If you have more than one IRA, you can take SEPPs from just one of your IRAs or you can aggregate two or more of your IRAs and calculate the SEPPs from the total balance. You can also use tax-free rollovers to ensure that the IRA(s) that will be the source of your periodic payments contain the exact amount necessary to generate the payment amount you want based on the IRS formulas.

SEPPs can be complicated--especially the modification rules. But taking the time to understand this important financial planning tool can be well worth the effort.