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2010 Roth IRA Conversion—Beyond the Basics

OVERVIEW

In 2010, all tax payers, regardless of income levels, are able to convert funds in regular IRAs to Roth IRAs. This pivotal law change provides additional retirement planning opportunities. But is the decision to convert right for you? This article reviews key Roth IRA conversion issues, beyond the basics.

If I convert my IRA to a Roth IRA in 2010, when do I pay the tax?

When Roth IRAs were first introduced in the late 1990s, tax law afforded taxpayers with adjusted gross incomes (AGIs) of less than \$100,000 the opportunity to convert from an IRA to a Roth IRA. It gave taxpayers a four-year spread—in other words, they were allowed to report the income evenly over four tax years. That was a nice feature to help smooth the way for people considering conversions.

Effective January 1, 2010, taxpayers with AGIs of more than \$100,000 are now eligible to convert IRAs to Roth IRAs, and perhaps benefit from a two-year averaging provision. Although the decision to convert is made in 2010, the taxable portion of the conversion can be taxed in the 2010 return, or postponed and split equally in the 2011 and 2012 returns. However, proposed and future tax legislation uncertainty is making people cautious. Individuals who were previously prevented from conversion opportunities in the past are typically in a higher tax bracket; therefore, this two-year averaging deferral doesn't necessarily look enticing. We know what tax rates are today, and we think we know what they will be for 2010, but if a taxpayer converts in 2010, will s/he be better or worse off by choosing to be taxed completely in 2010, or taking the two-year deferral?

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Estate Planning in 2010

OVERVIEW

Congress ended 2009 without passing estate tax legislation. As a result, we enter 2010 with no estate and Generation Skipping Taxes (GST) and with carryover basis replacing the step-up in basis at death rules. This article reviews issues to keep in mind for estate planning.

Since the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was passed nearly a decade ago, most estate planners believed that Congress would amend the estate and GST tax legislation before 2010 to avoid a one year repeal of the estate and GST taxes. There are indications that Congress may attempt to pass legislation in 2010 that would have a retroactive effect to the first of the year. This leaves taxpayers in a confusing position regarding what to do with estate planning in 2010.

Several bills have been presented to address this situation. These bills have a wide variety of provisions. Many contain provisions that would:

- Extend or expand the 2009 estate and GST rules,
- Re-unite the estate tax and gift tax exemption limits,
- Reduce the attractiveness of the popular Grantor Retained Annuity Trusts,
- Limit or eliminate the use of valuation discounts on family business interests,
- Limit the use of “Crummy Powers,” and/or
- Provide for the portability of one spouse’s unused estate tax credit to the surviving spouse.



Taxpayers must decide whether they are going to wait to see what Congress does in early 2010, or try to take advantage of opportunities and protect themselves from risk in these uncertain times.

For example:

- Individuals should have their estate planning documents reviewed immediately to ensure they still work properly if the estate tax is repealed when they pass away. Most clients’ estate planning documents use formulas to fund various transfers to family members, charities and trusts. These formulas often reference estate tax law or rules to determine the amounts of such transfers. How will these documents be interpreted if the references are to tax provisions that don’t exist? There could be over- or underfunding of various interests at death that are unintended by the taxpayer.
- There is a limited step-up in basis of assets allowed at death. The executor of the estate can allocate up to \$1.3 million of step-up to appreciated assets. However, many clients have revocable trusts, which are not controlled by the executor of the estate. Can those assets be subject to this step-up, or do clients need to reconsider the use of revocable trusts?
- Taxpayers should consider whether it makes sense to pay gift tax in 2010 at the scheduled 35 percent rate. In addition, some of these gifts could be made to trusts that benefit grandchildren. It may be that trusts created when there are no GST will not later become subject to reinstated GST.

There is a lot of uncertainty on what the law will be and the effective dates. If clients move forward with changes, they should draft their documents carefully in the event of retroactive legislation. ■



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Viruses and Malware—Are you Protected?

The threat from malicious software, e-mail and web scams continues to rise. This shouldn't be news. We've been fighting viruses since the 1980s. Business leaders, continue to make your organizations' defenses to these threats a primary focus. You must establish layers of protection to detect and, when possible, prevent incidents.

The first and most important layer for preventing incidents caused by last generation threats is still a malicious software prevention system, commonly called "antivirus software." Think of this layer of defense acting like a flu vaccine. It can't guarantee you won't get sick, and it must be updated regularly. If you do get sick, you still need to take care of yourself, and one protected person doesn't mean others are protected.

A comprehensive system should include a management console and an individual who monitors that console. The management console will show you which computers in your organization have out-of-date software or updates, haven't recently received a full-system scan or have been compromised.

Spam filters on your in-coming and out-going e-mail are important too. A major and growing source of malicious software infection comes from people clicking links in misleading, "phishing" e-mails. A good spam filter will keep most of these from your workforce.

A major source of spam and phishing e-mails is compromised computers acting as mail servers. By watching outbound spam filters, you will be alerted to these systems inside your organization. Properly configured firewalls can act as outbound spam filters by preventing and logging these unauthorized attempts to send e-mail.

The root cause of most incidents continues to be security flaws in software. Hopefully, by now, everyone knows they must stay current with updates to their Windows operating system software. But a gap continues to exist in most organizations when it comes to ancillary software. Malicious exploitation of flaws in Adobe's Flash Player, Acrobat and Acrobat Reader are increasingly found to be the source



of infection. Sun's Java, Microsoft's Internet Explorer and Office suite, and Mozilla's Firefox and other web browsers all must be kept up-to-date as well.

As technical prevention measures improve, phishing e-mails and false reports of infection from fake antivirus software are increasingly taking advantage of your employees. All the technical security layers previously mentioned do not matter if a member of your workforce deliberately, or unwittingly, chooses to install malicious software. A continuous awareness campaign is essential to keep employees from being fooled.

Despite the countless time and money spent fighting the problem, there is no single solution or product to keep an organization safe. Likely, there never will be. Instead, establish and maintain layers of protection to avoid exploitation of your organization. ■

OVERVIEW

The last several years have seen an exponential increase in the number of new viruses. Currently, nearly 600 new viruses appear each month—that's 20 new viruses each day. This article reviews virus and malware protection.



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Taxpayers are allowed until October 15 of the year following the year of conversion, whether or not the taxpayer elects to extend their tax return, to decide if they want to recharacterize (undo) their conversion.

Roth IRA—from page 1

Unfortunately, trying to project tax rates for 2011 or 2012 is fraught with uncertainty. But, if you convert in 2010, you will have the advantage of a “look back” period to see how the conversion and tax rate changes progress before making a final decision. By April 15, 2011, when you can pay taxes for a 2010 conversion, you will have more information available to make a final decision. When planning for the conversion today, one might want to discount the two-year deferral opportunity.

Once you make the decision to convert, you have until April 15, 2011, to decide if you want to pay the tax or file an extension. If you extend, which is advised if converting, the “look back” period is extended to October 15, 2011—the final date to make a decision of which year to report the taxation of the conversion. This “buys” the taxpayer time (until October 15, 2011) to make a final decision about how the 2010 conversion should be taxed. When extending the 2010 tax return, send a safe balance due extension payment to avoid penalties. Then, see what unfolds on the tax landscape by October 15, 2011, before making a final decision about taxing the conversion in 2010, or choosing the deferral of income equally into 2011 and 2012.

If I decide to convert, can I cancel the conversion later?

Taxpayers are allowed until October 15 of the year following the year of conversion, whether or not the taxpayer elects to extend their tax return, to decide if they want to recharacterize (undo) their conversion. This option allows taxpayers to see what unfolds with the value of the conversion. If the converted IRA builds in value, then conversion might be beneficial and taxpayers might not mind reporting income; the increase in value is tax-exempt.

If the converted IRA loses value, you may not want to report original income when the converted investment has declined in value. In turn, taxpayers have the ability to reconvert after recharacterizing the conversion, but subject to the following time limitation: the reconversion

must take place more than 30 days after the date of recharacterization or the tax year following the year of the original conversion, whichever is later.

Would it be beneficial to extend my return to October 15, 2011, to get a better look at the growth of the investment?

Yes. The maximum extended due date an individual can possibly get for a 2010 conversion is October 15, 2011. This extra time allows taxpayers to see what unfolds with the value of the converted asset.

From an investment standpoint, does it make sense to convert as soon as possible in 2010?

In a rising investment market, yes. We have no idea where the market will go and what will happen with taxes. It doesn’t hurt to convert and see where the market takes you, because you have the option to recharacterize later. If you’re anticipating a gain in the market, the earlier you can convert, the better.

Keep in mind, if you convert in early 2010 and investment returns hit low points in July, you may feel it necessary to recharacterize the conversion. If a taxpayer attempts to recharacterize in the same tax year, they have to wait to reconvert until the following tax year (January 2011). There is a risk that the market may pick back up and a taxpayer would be stuck until the following year to reconvert. You may want to consider recharacterizing as late in the year as possible in order not to miss out on other opportunities, because once you decide to recharacterize, you must wait until the following tax year to reconvert.

If I’m going to do the conversion, does it make sense to divide my IRA between different asset classes?

If you decide to diversify your conversion, then you would want to divide the converted IRA between different asset classes. If one asset class declines versus others rising, then you can selectively recharacterize the account that has

gone down in value, if desired. By segregating assets into different accounts, you have more options with which to make decisions. Timing the market is a guess. However, you have a rather liberal time frame, so don't get too worried about what happens in the short-term. You might as well wait to recharacterize until later in the year, so you can reconvert quicker. Rather than timing the market, we recommend doing a conversion as early as you can.

At the end of the day, whether you convert for estate planning, tax planning or other reasons, the decision to convert will depend on how and when you convert, recharacterize and/or reconvert. Investment decisions will also depend largely on your purpose. The tax laws provide flexibility in making these decisions.

Does age have any consideration in determining whether to convert to a Roth IRA?

Yes. It's not a good idea to do a conversion if you are anticipating that you will need to pull money from the Roth within five years, or before age 59 ½. Additionally, if the converted amounts are expected to be withdrawn to meet one's financial needs during retirement, it is a marginal consideration for those age 50 or older. Generally, the younger the individual is, the more advantageous the tax-free compounding of a Roth becomes.

Is there a penalty for withdrawal?

There is no penalty to an individual making a Roth conversion, regardless of their age. If you take a distribution from the Roth IRA within five years, or prior to age 59 ½, there is a 10 percent penalty tax, unless one of the other exceptions to the penalty apply, such as death, disability or first-time homebuyer.

Can I make contributions to the Roth IRA if I've already converted?

Contributions to a Roth IRA will be determined separately from the actions of making a conversion. However, if you are considering

the possibility of a recharacterization, then you might not want to mix any new Roth contributions into the same account as the conversion.

If I want to pull money from a converted Roth in three years, is it still an advantage for me to use a Roth?

Roth conversion might not be a viable solution if you will need money within a short time for retirement needs. The more time you have to allow the tax-exempt growth potential of the Roth to unfold, the more benefits you could achieve.

Is there any reason why I should not do a Roth IRA conversion?

There will always be a downside if you pay more tax by declaring the conversion than you otherwise would have paid during your retirement years (withdrawing money at a lower tax bracket). This is a difficult aspect if you're talking about converting a sizeable amount. It doesn't hurt to run some numbers. If you decide to convert, you can always recharacterize. Having the liquidity or funds available to pay the income taxes relating to a conversion is one of the largest considerations in this discussion. ■

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Roth conversion might not be a viable solution if you will need money within a short time for retirement needs. The more time you have to allow the tax exempt growth potential of the Roth to unfold, the more benefits you could achieve.



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■ The Ponzi Scheme:

A Fun House Ride to Avoid

OVERVIEW

Over the past few years, there have been stories all over the news about various “investments” that have fallen apart, and people who have lost a lot of money. The following article reviews Ponzi schemes and how you can protect yourself.



The people running the scheme must spend a lot of time telling people how well they are doing and showing off how well the investments are making money.

We have all heard the stories about someone being taken advantage of and losing a lot of money because someone they knew had made a bad investment. We tell ourselves, “that could never happen to me, I am too smart for that.” The problem is, we all want to trust people, and believe they are honest and will do the right thing. The reality is: that is not the world we live in.

All Ponzi schemes must have the following five key elements in order to work and separate investors from their money.

A Benefit

This part is easy. Money is always the benefit; the accumulation of more money is the reason people get involved in these matters.

A Setup

The person touting the investment has an “air” about him that he is the best there is at investing money and that your money is safe.

An Appearance of Credibility

The person running the Ponzi scheme places people and structures around him/her which generate an appearance that everything is “above board” with the company.

Initial Investors Paid Off

For several months or years, depending on the size of the scheme, the initial investors are paid according to their agreement with the company, if not better. Many times investors will re-invest their “profits” back into the company.

Communicated Successes

The people running the scheme must spend a lot of time telling people how well they are doing and showing off how well the investments are making money.

How to Protect Yourself

Protecting yourself from a Ponzi scheme begins with just a few steps:

- First, make sure the story you are being told is not too good to be true. There are very few legitimate investments that are going to pay a 20 percent-plus return.
- Second, do an Internet search on the company. You might be surprised by just how much information is available to the common Internet user.
- Third, make sure the person to whom you are entrusting your money is registered with the Security Exchange Commission (SEC), for those who manage more than \$25 million.
- Fourth, make sure the person is a custodian of your money. Don’t use a “money manager.” Many times, a money manager has a difficult time adequately explaining the investment they are asking you to make. If you don’t understand the investment, don’t invest.
- Finally, never put all of your “eggs in one basket.”

Take some extra time to investigate the company to which you will be entrusting your money. It could save you a lifetime of heartache and sleepless nights. Be smart and ask questions. ■



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Link Your Company's Strengths with Enterprise Risk Management

All companies are exposed to risks. When properly managed, a company can focus on its strengths and opportunities, even in a down economy.

How do companies focus effectively on their futures while managing risk?

When companies review their performance each year, they look at budgets, goals, strategies and objectives. Management's reflections on past successes and failures are built into the forecast for the coming year and beyond. Renewed opportunities begin to surface, but lingering challenges of the current economic environment may limit the responses companies want to make.

Enterprise Risk Management (ERM) is a process to help companies moving forward in an uncertain world better understand and manage risks. Effective ERM programs focus on a company's past successes and capitalize on its strengths to accelerate a successful future.

How can my company put Enterprise Risk Management into practice?

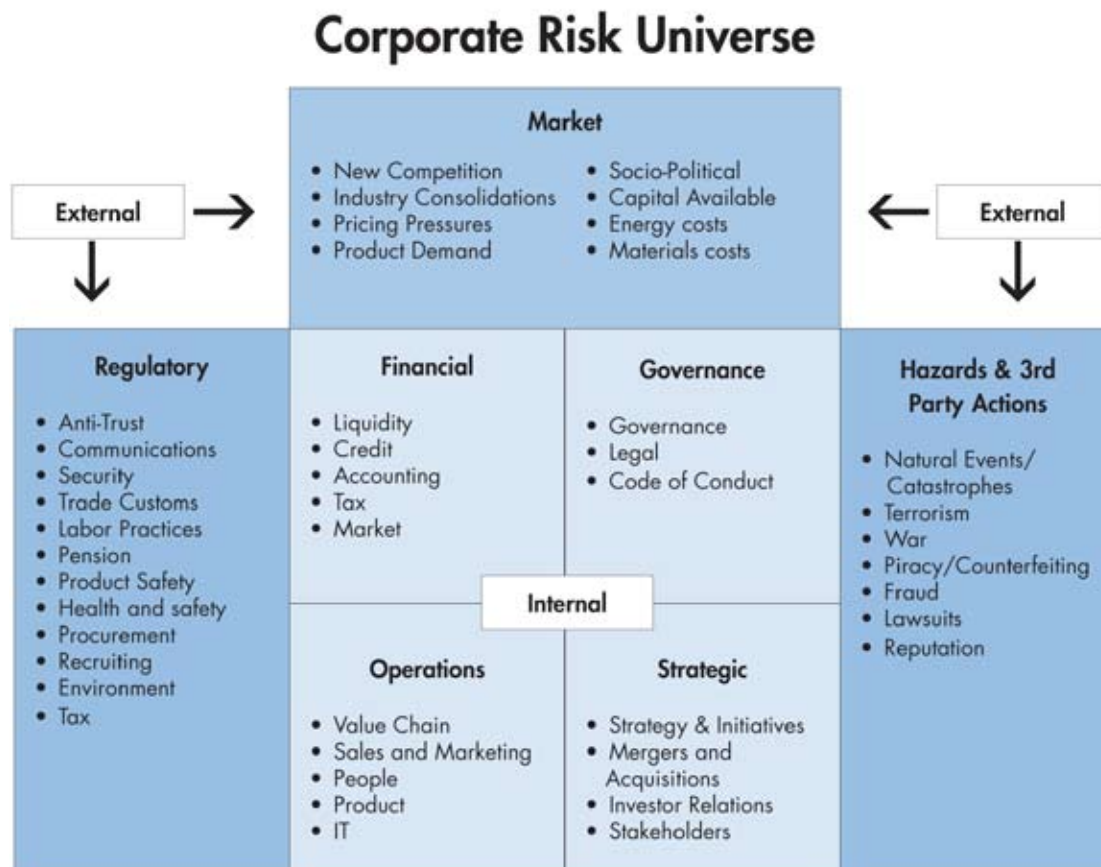
One of the first steps in the ERM process is to adequately assess your current risk management practices. Eide Bailly utilizes the Corporate Risk Universe (below) to help clients understand their current risks from a holistic perspective. We facilitate questions like, what are the internal and external risks your company faces on a daily basis? How do you currently react to those risks?

Internal risks can typically be compartmentalized into four categories: financial, operations, governance and strategic. Risk management has historically focused on the financial, operations and governance areas of risks. These risks were relatively easy to identify and did not take much time to respond to, or develop effective controls

OVERVIEW

With the economic environment, it is apparent that companies need to understand how risks impact their organizations as a whole. Enterprise Risk Management (ERM) utilizes current risk management tools and processes, while identifying areas of opportunity based on the company's strengths and strategic objectives.

ERM—continued on page 8



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ERM—from page 7

and responses around. Insurance, alternative risk finance (i.e., hedging, captives), stop gaps and avoidance are common techniques used to transfer and mitigate identified risks. Strategic risks, such as mergers, acquisitions and strategic planning, however, are rarely openly communicated within an organization. ERM can help facilitate better communication.

How can I effectively manage external risks?

External risks can typically be separated into three categories: regulatory, market, and hazards or third party actions. Companies rarely have control over external risks, but their reactions to external risks may propel a company forward or cause them to stumble.

The ERM process increases effective communication throughout the company, which helps give employees a better understanding of the company's overall risk appetite. A chain reaction occurs; as employees increase their awareness of external risks that could adversely impact the company, executive management also starts to become aware of emerging external risks sooner than competitors because new communication channels open and cross-functional data becomes available.

Companies with effective ERM programs become more resilient to emerging risks and seize opportunities when other companies are struggling to understand what is happening. ERM cannot control external risks, but it does provide companies with the tools to control their risk response and focus on the company's strengths.

As an example, companies spend a lot of energy trying to understand how our unstable economy will impact their organization. ERM can stimulate communication throughout the company regarding strategy and risk management, which can result in managers better assisting executives in understanding emerging threats and potential opportunities that come with economic change.

ERM provides the tools and process to help a company identify its risk-related areas and opportunities, and determine ways to link the company's strengths to its strategic objectives, even in a struggling economy. ■



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