PILLAR PACIFIC
CAPITAL MANAGEMENT, LLC

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Mindy L. Ying, MBA
President & CEO

Arthur T. French, CFA, CIC
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Sally E. Haff, CFA
Senior Portfolio Manager

Sonny C. Lin, CFA
Senior Portfolio Manager

Alan K. Chuang, CFA, CPA
Portfolio Manager &
Business Development Officer

Lily L. Ku, CFP®
Financial Planner

Hongmin Lu, CFA
Compliance Officer &
Quantitative Analyst

Devon M. Chan
Operations Analyst

Offices:

Southern California:
2540 Huntington Dr.
Suite 105
San Marino, CA 91108
Tel: (626) 286-4029
(888) 295-4419
Fax: (626) 286-0624

Northern California:
333 Gellert Blvd.
Suite 121
Daly City, CA 94015
Tel: (650) 758-0130
Fax: (650) 758-0131

www.PILLARPACIFIC.com

~ Year End Tax Tips for 2009 ~

By Alan K. Chuang, CFA, CPA

As we enter the fourth quarter of the year, it is always a good idea to revisit your tax situation and take the appropriate steps to minimize your tax obligation for the year and plan for the future. The following is a few areas to take advantage of before the year ends.

1. **Maximize Contributions to Retirement Accounts**: Tax-deferred retirement accounts are one of the best investment vehicles to compound your returns tax free while also reducing your current taxable income. Some 401(k) plans allow for "catch-up" contributions if you have not made the maximum $16,500 allowed for 2009. The same benefits apply for traditional IRA contributions so remember to contribute the $5,000 maximum (for you and your spouse, or $6,000 each if age 50 or older) before April 15, 2010. Lastly, self employed people should set up a Keogh, a Solo 401k, or a Defined Benefit plan by December 31st. Once the plan is in place you can contribute up to $49,000 for the defined contribution plans and up to $195,000 for a defined benefit plan that is also deducted from your current taxable income.

2. **Review IRA Distributions**: 2009 is unique in that Congress has waived the requirement for minimum distributions for your IRA. Traditionally, if you have reached 70 ½ there is a mandatory withdrawal from a traditional Individual Retirement Account. But in 2009 you can choose to keep that money in the IRA. This decision largely lies in whether you need the cash from the distribution to cover living expenses. If not, consider letting the IRA continue to participate in the market recovery. Another option for the charitable minded who do not need the withdrawal, IRA owners age 70 ½ or older are permitted to directly transfer tax-free, up to $100,000 in 2009 to an eligible charity.

3. **Watch Out for the AMT**: Certain transactions will trigger the alternative minimum tax, so plan accordingly. The AMT exemption amounts for 2009 have increased to $46,700 ($70,950 if married filing jointly/qualifying widow(er); $35,475 if married filing separately). The AMT is calculated separately from you regular tax liability and you may have to pay it if your itemized deductions are too high, you have large state tax liability, you exercise stock options, perform a Roth conversion, or experience another triggering event. It is always best to check with your tax accountant for your particular situation as sometimes it is beneficial to pay the AMT in the current year to better position for the future.

4. **Prepay State and or Local Taxes**: If you feel that your tax bracket will remain the same for next year, AMT is not an issue, and you would like additional deduction, consider paying your state and local taxes early and take the federal deduction in the current year.

5. **Contribute to Charity**: It is always a good idea to make sure all your donations to your favorite charities are given before the year ends. As an alternative to giving monies to your charity, consider donating appreciated stocks you have held longer than a year. You not only then avoid paying tax on the appreciation, but will also be able to deduct the full fair market value of the stock.

6. **Gifting**: Although you can not take a tax deduction for gifts to family, it is still important to consider for estate tax planning. You can give up to <u>$13,000</u> for you and your spouse to as many people as you wish. Assets given away during your life, and any future appreciation, will not be included in your estate and taxed at the time of death. The deadline to make any gifts is December 31st and cannot be retroactively given; once the deadline is passed the exclusion for that year passes. Also note that gifts are considered given at the time checks are cashed by the recipient and not when written.

7. **Offset Gains with Losses**: One of the benefits at Pillar Pacific Capital is our Realized Gain and Loss report that you receive in October for year-end tax planning. It is important to use this information and plan accordingly with any other gains or losses you may have incurred during the year. Although we do not want to let "the tax tail wag the financial dog" we can take this time to review your portfolio along with the "Wash Sale Rule" strategy and help offset capital gains and ensure all holdings are still appropriate for your investment goals.

~ Special Tax Consideration: The Roth IRA Conversion ~

This past year, our government has battled one of the worst recessions in history and supplied unprecedented bailouts of corporations. As a result this year's federal budget deficit is at a staggering $1.6 trillion. One unavoidable fact seems apparent, taxes will go up. Politics of course are always changing, but most tax experts agree that by 2011, tax rates will be higher, particularly for those with higher income.

One possible strategy to take advantage of a relatively lower current tax rate is the conversion of your traditional IRA into a Roth IRA. For tax years after 2009, all taxpayers are allowed to make Roth IRA conversions, regardless of income level. Previously, conversions into a Roth IRA were limited to those earning less than $100,000 AGI. Also, for 2010 only, you have the option to pay all the taxes on the conversion in 2010 or average the taxes on the conversion over the next two years (i.e., 2011 and 2012). But remember the current tax laws only apply through 2010 and allows for an increase in tax rates starting in 2011.

Current Federal Income Tax Rate	*Upon Expiration after 2010*
10.00%	10.00%
15.00%	15.00%
25.00%	28.00%
28.00%	31.00%
33.00%	36.00%
35.00%	39.60%

Source: Economic Growth and Tax Relief Reconciliation Act of 2001

Making the decision:

Remember that contributions to a traditional IRA were deductible. When a Roth IRA conversion is initiated, you will pay income tax on the amount you choose to convert similar to an IRA distribution. The tax paid is calculated based on your ordinary income rates. In general we like to postpone taxes as long as possible, but Roth IRA's have several advantages:

1. All withdrawals after 59 ½ are tax free and that includes capital gains, dividends, interest and withdrawals of principle.
2. There is no required minimum distribution at 70 ½ , allowing your money to grow tax-free for a longer period of time
3. Inherited Roth IRA's are passed onto beneficiaries with the continued benefits of tax free growth (though beneficiaries are required to make withdrawals over their lifetime).

Since Roth distributions are not taxed at time of withdrawal, then a Roth becomes more attractive if you expect your tax rate to be higher in the future than it is now. An easy example of this compares $1,000 kept in a traditional IRA versus converting to a Roth. Assuming an 8% growth rate and 25% present tax rate and 35% future tax rate, in ten years the Roth IRA will have $1,619 versus $1,403 for the traditional IRA. Even at the same tax rate, a Roth may be more attractive if you can pay the tax outside of the IRA. Using the same example above and a constant rate of 25% tax rate, the Roth IRA will be worth $2,159 and the Traditional IRA would be $1,619. If money is used from the IRA to pay taxes then the benefits of a Roth conversion are negated (Tax neutrality).

Therefore in general, a Roth conversion may make sense if:

- You believe that you will be in a higher tax bracket when you withdraw from your IRA
- You have a long time horizon, **and** can pay the tax from sources other than your IRA (taxable brokerage account or bank accounts) **or**
- You will not be using this money in retirement and plan on leaving the funds to your heirs.

Conclusion:

Eligibility for a Roth conversion in 2010 does not mean it should be exercised. For high earning taxpayers already in the top tax brackets the benefits of a conversion are reduced. Nevertheless, in certain circumstances a Roth conversion can have significant benefits particularly for those planning to pass on the assets to future generations. Each situation needs to be evaluated on a case by case basis. At Pillar Pacific Capital, we are here to service all your wealth management needs.