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Do Roth IRA Conversion Rule Changes Help You?

Why would you volunteer to pay income tax next year by converting a traditional IRA to a Roth IRA? If you leave things alone, you won't owe any current tax on the assets in your account, regardless of their investment performance. But the promise of a future tax payoff—combined with the prevailing economic conditions—may warrant this unusual approach. And thanks to a recent tax law change, a conversion to a Roth in 2010 will be a possibility for all investors, regardless of income.

With a traditional IRA, contributions may be tax deductible, but the amount you deduct and subsequent earnings will be fully taxed as income when withdrawn during retirement. (The same rules apply to IRAs holding assets rolled over from traditional 401(k)s or other employer-sponsored plans.) And you generally must begin taking those taxable distributions during the year after the year in which you turn age 70½.

In contrast, contributions to a Roth IRA are never deductible, but qualified distributions from a Roth that has been established for at least five years are completely tax free. And because the government won't benefit when you take distributions, it doesn't require you to take them.

Until now, the catch has been that high-income individuals can't contribute to a Roth IRA, and converting a traditional IRA to a Roth hasn't been allowed if your adjusted gross income exceeds $100,000. The latter rule changes in 2010, when the income cap for conversions is eliminated. And though a conversion to a Roth requires you to pay income tax on the amount you convert, if you make the conversion in 2010, you're allowed to spread out your tax payment over 2011 and 2012.

Choosing between saving for retirement with a traditional IRA or a Roth is in part a question of whether it's better to pay the IRS sooner or later. Being taxed on current contributions to a Roth IRA or for a conversion from a traditional IRA takes money out of your pocket now, but you may do better later, either enjoying tax-free distributions or passing along the account to your heirs, whose withdrawals also won't be taxed. But the law permitting anyone to convert to a Roth, coupled with the bear market's depressed asset values, adds interesting twists to this debate. Consider these four reasons it may pay to convert.

1. You'll pay less to convert an IRA whose value has plummeted. Rare is the investor who hasn't seen retirement account values fall by at least 25% during the bear market. As painful as that has been, however, it can be an advantage if you choose to convert to a Roth IRA in 2010. You'll be taxed on the value of the account at the time of the conversion, regardless of what it may have been worth a few years earlier. Suppose the assets in your IRA were worth $500,000 a year ago,

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You Could Buy A Dream, Or Do Real Financial Planning

TV commercials and newspaper ads extol the advantages of a 401(k) to build retirement savings. They paint a rosy picture of golden years filled with travel, hobbies, and fun activities, and talk about how, with the miracle of compounding, account balances can grow to six- and seven-digit sums. Don't fall for it. They're selling dreams.

Understand that there's a big cost for retirement. You may need more than you realize to make your retirement plan work.

Many investors have a financial blind spot. They make plans for retirement and make investments, but then fail to match up the two. If you're going into your retirement with $500,000 in savings, for instance, you'd better not have $1 million worth of retirement activities planned. The same applies to kids' weddings, vacations, and other life events. Plans have to be funded from your savings and investments.

No, you can't project costs exactly. Plans are ever-changing. But as you approach retirement, you must have a good idea of how much you will need to live the lifestyle you want. Then, you can determine whether your plans are realistic. That's financial planning—not selling dreams.

Colleen & Rob

Marital Trusts: The Devil Is In The Details

The marital trust is a powerful estate planning tool that can maximize estate tax benefits and allow you to control what happens after your death. But mistakes in execution, particularly involving funding, could undercut its usefulness.

Though the federal estate law has been in flux during recent years, there has been one constant—that one spouse can receive an unlimited amount from the other without gift or estate tax liability. (Note: The marital deduction is generally disallowed for non-citizen spouses.) The basic idea of a marital trust is to fund it with those inherited spousal assets. All trust income goes to the surviving spouse, who may also be able to use some of the assets—living in the family home, for example, or tapping trust principal to pay for long-term care.

One common alternative to the marital trust is known as a credit shelter trust (or bypass trust). By any of these names, a credit shelter trust is designed to make sure each spouse's personal exemption for federal estate tax—$3.5 million in 2009—is fully utilized in reducing the overall taxes for a couple's estate. Suppose you and your spouse together have assets worth $7 million. You could set up the trust so that when either of you dies, that person's exemption is used to fund the trust with $3.5 million. That tax-free transfer reduces the value of the estate to $3.5 million, and the trust income can be paid to the surviving spouse. Then, at the second spouse's death, the trust assets are directed to your children or other heirs without estate tax liability. The remaining $3.5 million (under current law) outside the trust can also be passed along to beneficiaries without federal estate taxes using the second spouse's exemption.

For this scenario to play out exactly that way, however, you would both have to die in 2009, as estate tax laws are in flux. The federal estate tax is scheduled to be repealed in 2010, only to be revived in 2011 under revised rules, including an exemption of just $1 million. It's probable there will be legislation to prevent the repeal of the estate tax in 2010, as the government is in need of revenue to fund its operating deficit. Until a permanent solution for the estate tax is created, estate plans must be crafted carefully and revisited annually to avoid unintended consequences.

Funding a credit shelter trust can also be tricky. Normally, it's funded through a pecuniary or fractional bequest. A pecuniary bequest sends a fixed dollar amount to the trust, while a fractional bequest delivers a percentage share of the assets. Problems may occur if the language of the will leads to underfunding and unexpected estate tax for the heirs. Since there can also be errors in how individually or jointly owned property is used, it is very important to consider with which assets to fund the trust.

With all of the potential snafus, it's essential that everything is handled properly. We can work with you and your attorney to create a trust that meets your objectives. ●

Red Flags Raised By Madoff's Scheme

The recent revelations concerning Bernard Madoff's "Ponzi scheme" have put the fear of fraud in investors. Even if you never came anywhere near Madoff Securities, you may sympathize with those who reportedly were bilked out of billions of dollars. And you'll probably wonder whether something similar could happen to you.

According to Madoff's indictment, his truly was a scandal for the rich and famous, who were drawn in not by a chance to make a quick killing but by rock-steady annual returns of 10% to 12% regardless of the state of the markets. Although there are no guarantees that any financial manager is on the up-and-up, a closer examination of Madoff's operation would have revealed several "red flags," giving investors pause.

The mere fact that he had an unwavering track record should have been the first and biggest warning sign. Normally, even the best-diversified portfolios will rise and fall with the markets; the hope is merely for a smoother-than-normal ride and better-than-average results. In addition, Madoff took the unusual step of assuming full custody of client assets, rather than using a nationally recognized custodian. That, too, should have set off alarm bells. But there were also other problems.

Madoff's books were audited by a little-known accounting firm. That's extremely unusual for such a major investment company. Normally, big investment managers use a Big Four national accountant or at least a prominent regional firm—and investors thinking about entrusting Madoff with millions of dollars in assets should have been wary.

The lack of information on Madoff's website and in his brochures was telling. There was nothing about the qualifications or designations of the firm's money

The Dynamics Of China-U.S. Economics

In the autumn of 2008, China became the United States' biggest creditor, and Chinese leaders have wasted little time in flexing their growing economic muscle. China is demanding a stronger voice in global economic affairs and has proposed a new international currency that would supplant the dollar as the world's dominant medium of exchange. Should U.S. investors worry about China's emergence as a powerful economic force? And how will this "new world order" affect American consumers?

The Chinese have been buying up U.S. Treasury bonds for years, and by January 2009, China held $740 billion in U.S. Treasury securities, or 24% of the total outstanding Treasury debt. In September 2008, China had surpassed Japan as the U.S.'s largest creditor. China also has amassed the world's largest cash reserves, totaling about $1.9 trillion, and maintains the world's most lopsided trade surplus with the United States. That reflects the fact that China has become the world's No. 1 producer while America has become a nation of avid consumers. Monies from throughout the world are pouring into China's booming economy while American dollars flow outward to buy more goods and services.

These trends have led to controversy, with U.S. officials accusing the Chinese government of manipulating its currency to keep its exports competitive. But the Obama administration backed away from those claims early in 2009 after China allowed its currency to appreciate slightly against the dollar, thus slowing the nation's accumulation of cash reserves.

For now, leaders of both countries have agreed to work together to fight the global recession, joining countries in the European Union and around the world. But in the long run, China is building up a potentially alarming amount of influence over the American economy, analysts say. "The scale of financing the U.S. now receives from China truly is unprecedented: it now not only tops the largest inflow the U.S. ever received from another country, but it is clearly by far the largest inflow the U.S. has ever received from a government that the U.S. doesn't consider a close military ally," writes Brad W. Setser, geoeconomics fellow at the Council on Foreign Relations, in his blog for the Center for Geoeconomic Studies. "And I don't think it is in the interest of the United States to rely so heavily on a single country's government for financing."

Chinese leaders have recently expressed concern about the strength of the U.S. economy—and, by extension, the safety of China's Treasury investments—and signaled a desire to diversify. Should China shift a significant amount of money out of U.S. government bonds, other international and domestic investors could follow the Chinese lead. Any run on Treasury bonds would hurt the U.S. government's ability to pay for hundreds of billions of dollars in recession-fighting stimulus spending and would increase borrowing costs for U.S. companies and individuals. Such a move could, however, improve the trade deficit, because it would weaken the dollar, making U.S. exports more affordable. Currently, the U.S. imports from China five times as much as it exports to China.

While China cut back on U.S. Treasury purchases earlier this year, analysts agree that at least in the near term, the Chinese will continue to invest in U.S. bonds, both to maintain China's trade advantage and because the global recession presents few safe investing alternatives. Still, China's emergence as America's No. 1 creditor signals a basic change at a time of great economic uncertainty. During past economic downturns, the U.S. was always the largest creditor nation in the world. That was a good position to be in, because it meant other countries owed the U.S. more than it owed them.

During the current global recession, the reverse is true. America has become the world's largest debtor nation. As long as interest rates stay low, that alone is not a problem. However, as interest rates increase, it will become more expensive for American companies and consumers to borrow money, for everything from business equipment to houses. And that can only make emerging from the recession a longer and more difficult process. To put individual households and the country as a whole on more sustainable footing in preparation for future downturns, Americans will need to make the painful transition from spending to saving more of their hard-earned dollars. ●

managers, and scant information about Madoff's process for managing assets. If investors had compared these marketing materials to those of other, more forthcoming investment firms, they might have been more inclined to question Madoff's apparently remarkable results. Those who did try to decipher how Madoff worked his magic found they couldn't replicate his results—it just seemed impossible to deliver that kind of performance. It was.

There was no evidence of diversification. The kind of astonishingly steady returns Madoff used to attract investors, if feasible at all, should require broadly spreading assets over many kinds of investments and regularly rebalancing to keep investment risks under control.

As more details about Madoff's dealings emerge, investors may get a clearer picture of what went wrong. In the meantime, the scandal reminds everyone that there are no shortcuts to investment success, and that when results seem too good to be true, they almost always are. ●

Four Steps *Not* To Take Right Now

As the tough economic times push on and stock prices fluctuate, it's hard to know what moves to make as an investor. Though the panic you probably felt during the early months of the bear market may have ebbed, your account balances still aren't fun to look at, and the direction of the market is anything but certain. Was the spring-summer market rally the first leg of a new long-term bull market? Or will unemployment, lackluster corporate profits, and a shift from consumer spending to saving post-pone the recovery and keep share prices volatile?

Definitive answers may be a long time in coming. But in the meantime, there's no reason to abandon the fundamental investing principles that have worked for you in the past. Here are four moves *not* to make now.

1. Keep your money idle. It's tempting to sit on the sidelines while the markets sort themselves out. But there are two problems with that approach. The first is that if you're going to reach your retirement goals, you'll need growth in your portfolio, and that means putting your money to work in suitable investments. The second is that if your plan is to sit out until markets improve, you'll inevitably miss much of what the market provides. The best time to buy is when the market is down, not when you feel comfortable, and trying to time your entry and exit into the market almost never works.

2. Chase the golden goose. Trying to get well in a hurry by jumping on the bandwagon for high-flying stocks or high-yielding bonds is another common investing mistake. The best time to invest in a particular sector or category is before a market run-up, not after. You'll probably be too late to the party if you invest heavily when substantial gains have already been realized, and you may be left holding overvalued investments vulnerable to sharp declines, especially while the markets remain volatile.

3. Rely too much on "safe" investments. Diversifying your portfolio with reasonable allocations to low-risk, low-return investments such as bonds and money markets is smart, but veering too far in that direction can be just as damaging to your long-term prospects as chasing hot stocks or trying to time the market. "Safe" investments bring their own risks, including a loss of value when interest rates rise and inflation picks up.

4. Stop saving for retirement. When times are tough, paying bills may have to take precedence over saving. But your future needs are also crucial, and continuing to contribute to your 401(k) or other retirement plan—even, or especially, if its value has plummeted—is the only way to ensure that you'll reach your long-term goals. These turbulent times too shall pass, and it only makes sense to keep working toward your ultimate objectives. In fact, cost averaging into your 401(k) enhances returns when the market drops—a reward for continuing to save. ●

Roth IRA Conversion

(Continued from page 1)

but in 2010, they are worth only $400,000. At the top current income tax rate of 35%, that saves you $35,000.

2. You'll avoid a higher tax bill later if rates rise. With individual tax rates at near-record lows and tax revenue falling far short of federal budget commitments, tax rates are likely to go up in the near future. It may be better to take your lumps under current tax law—even if all or part of the conversion is taxed at the top rate of 35%—than to risk losing much more of your investment to the IRS later.

3. Converting to a Roth IRA gives you maximum flexibility on distributions. There's not much give in the rules on withdrawals from traditional IRAs and 401(k)s. Beginning the year after the year you reach 70½, you'll face minimum annual distributions designed to use up the account during your expected life span—and you'll pay a 50% penalty on any shortfall from the required amount. With a Roth, you can take as large or small a distribution as you choose each year, and you have the option of leaving the account intact to provide tax-free income to your heirs.

4. A partial conversion to a Roth lets you customize your tax liability and benefits. A Roth IRA conversion needn't be an all-or-nothing proposition. You can convert as much or as little as you want each year (although the option of stretching out tax payments applies only to conversions in 2010). Making a partial conversion lets you limit current payments to the IRS while also providing some tax-free income during retirement.

We can help you decide whether a conversion makes sense in terms of your unique situation and overall financial goals. ●

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