

Financial Foresight

Dempsey Investment Management • Fall 2009 Edition

Why Convert to a ROTH?

Do you think income tax rates will be higher in the future? Do you want to control when you must withdraw money from your IRA? Is your IRA portfolio down over the last few years? If you answered “yes” to any of these questions a ROTH conversion may be a great strategy for you. The market pullback has certainly damaged some portfolios but there may be a way to use that to your advantage. Let’s look at how you could gain some benefit from this pullback.

For example, assume you purchased 100 shares of a stock 3 years ago for \$5000 in your IRA but it is now only worth \$2,500. You could sell the stock or hold it for a rebound in price. If you are confident about its eventual recovery, a better move (assuming you qualify) may be to convert that holding into a ROTH IRA. Any eventual increase in value would be tax free. You would pay tax on the \$2,500 conversion but this strategy can save you money in the long term and provide you with control over future disbursements. In addition, ROTH IRAs do not have required minimum distributions, giving you more control over taxes in retirement. There are some important details to be aware of:

1. You can selectively choose which investments to convert. You do not have to convert the entire account.

2. In order to qualify for a ROTH conversion your 2009 modified adjusted gross income (MAGI) needs to be below \$100,000.

3. In 2010 there will be no income limitations and the conversion tax can be paid over two tax years, in 2011 and 2012. This option will create great tax and estate planning strategies to a variety of investors.

One of the main reasons to convert your IRA to a ROTH is that you feel tax rates will be higher in the future. This could be because your income will have moved you up into a higher bracket, or federal tax rates

will have increased. Given the huge federal deficits the second assumption seems inevitable. The following example shows how a conversion can work in your favor: Let’s assume a married couple, 50 yrs. old, has taxable annual income of \$50,000, an IRA worth \$100,000, and are in the 15% tax bracket. They are looking at a conversion of \$17,900 from the IRA. (Money withdrawn from an IRA adds to your taxable income. Only \$17,900 was withdrawn because when it is added to the \$50,000, it will still be \$1.00 below the next higher tax bracket. However, this strategy can still work for those in higher tax brackets.) Here are the two possible outcomes depending on whether you convert or not:

IRA (no conversion)	
Year 1	\$17,900
10 years @7% annual growth	35,212
Less 25% tax*	-8,803
Net after 25% tax	\$26,409
Convert IRA to ROTH	
Year 1	\$17,900
Less current 15% tax	-2,685
Net contributed to ROTH	15,215
10 years @ 7% annual growth	\$29,930
Net after 0% tax	\$29,930

*assumed future 25% tax bracket

You can see that by converting you would have saved \$3,521 in federal taxes assuming you withdrew the full amount from both accounts after ten years. Four things will make this strategy even more successful: more time for growth, higher growth rates, higher future tax rates, and paying the tax from non-IRA money. The example above assumes taxes are taken out of the IRA account. I typically recommend that clients pay the taxes from another source as opposed to tapping their IRA.

A ROTH conversion may not be a great

strategy for:

1. Investors already drawing down their IRA to live on.
2. Investors who feel their tax bracket will be lower in the future.
3. Those for whom conversions would push them into a higher bracket.
4. Those with MAGI above \$100,000, therefore not eligible.

There is an additional benefit worth mentioning regarding ROTH conversions. The laws allow you to reverse your decision by “recharacterizing” a conversion. Assume on October 1st you convert a stock worth \$20,000 from your IRA to a ROTH. You will then pay a tax of \$5000. (We assume a 25% tax bracket for this example.) Your bet on a stock rebound does not pan out and the stock goes down to \$12,000. You are allowed to reverse this conversion for the current tax year. You will “recharacterize” to the regular IRA like it never happened and avoid the tax. You have until your tax filing deadline (which may include extensions). If you converted last year, you have until October 15th to recharacterize and refile.

Consult with your accountant for tax advice, as there may be additional tax implications with ROTH conversions. Your investment advisor can discuss with you how a ROTH conversion may impact your portfolio.

Additional Year-End Tax Tips

529 Plan: Often when I speak to parents who have children presently enrolled in college or in late planning stages, I ask them if they are funding a 529 plan. Many respond that they feel it is too late now. From a stock market point of view they may be right, but what they may not realize is that many plans, including the Vermont TIAA Cref plan, offer state tax credits for annual contributions. The money can be deposited into a money market or savings type of account, so you are not assuming

risk from the stock market. Qualifying account owners filing a joint tax return in Vermont can earn up to a \$500 tax credit each year for a \$5,000 contribution (per child). \$250 tax credit for single filers contributing \$2,500. Even if you child is a junior in high school, you could be saving \$3,000 over the next six years. Other states may offer their own tax credits. Please visit www.vheip.com or contact me directly for more information on the Vermont plan.

Health Savings Account: Do you have a high deductible medical plan? Are you funding a HSA? If you qualify but are not funding, you are wasting a great opportunity to lower your taxes and/or reduce the cost of your medical purchases. For 2009 an individual can contribute \$3000 and a family can contribute \$5,950 plus a \$1,000 for those age 55 plus. These contributions lower your taxable income and if you use the funds for medical purposes the money

comes out tax-free. A taxpayer in the 25% federal bracket would save \$1,737.50 with the maximum contribution of \$6,950. If you don't need the money, you can let it grow tax deferred for later use. Before age 65, non-medical withdrawals are taxed as ordinary income and subject to an additional 10% penalty. After age 65, the 10% penalty is eliminated. Check with your accountant or health insurance company for more information.



Plug Those Money Leaks

By Robyn M. Young

Today, people are looking for ways to save money. One of the best ways to reduce expenses is to find and plug "money leaks," ways that money seeps out bank accounts when you are not paying attention. In the course of my daily money management work with clients, I have found five common money leaks:

Late fees are extra charges companies tack on to a bill when it is not paid by the stated due date, and can be as much as \$30. When several bills are not paid on time, late fees can cost a couple hundred dollars over and above the regular amounts due.

It is worthwhile to pay attention to due dates, especially if you carry a balance on your credit card. Late credit card payments, regardless of how much is paid, can cause the card's interest rates to increase dramatically. Some credit card companies will also increase your interest rate if you are late paying other bills.

ATM fees occur when you use an ATM at a bank other than your own. Often there are two fees: the first from your bank and the second from the bank whose machine you are using. Although ATM fees are small, they add up if you make regular withdrawals at other banks. ATM fees cost one of my clients \$15.75 a month. This is \$189 a year. His own bank was a half mile away from the machine he regularly used.

To avoid ATM fees, plan your cash needs ahead so you get to your bank's ATM when

you are close by. If convenience is an issue, consider switching banks.

Bank account fees will show up on your monthly statement. Banks charge fees to cover their costs on certain services, such as wiring money and stopping payment on checks. Some fees can be avoided, however. For instance, a monthly fee is deducted when your balance falls below a designated amount. Or, a fee is assessed for online banking privileges.

If you see fees on your bank statements, meet with a representative from your bank to learn whether there is another account that better meets your needs. If not, investigate other banks. If you bank on line, look for an account that provides this service free.

Overdraft fees are bank charges you incur if you "bounce" a check. Overdraft fees can be \$30 or more each. Another of my clients once bounced seven checks in one month. \$210 in fees leaked out of her account when she wasn't paying attention.

Often overdrafts occur when you make debit card purchases, ATM withdrawals and automatic bill payments. These are easily forgotten. Keep in mind that many companies now process checks as electronic transactions. This means the money is withdrawn from your account almost as soon as the company receives payment. You no longer have four to five days to get money into your account to cover the checks you just wrote.

To avoid overdraft fees, keep an up-to-date checkbook register. When you make an electronic withdrawal from your checking account, record it right away. If your electric

company withdraws its payment from your account each month, record the withdrawal the day you receive the statement. Treat every withdrawal - whether it is a check, ATM transaction, debit card purchase or electronic bill payment - as if you just handed over cash. Keep that amount of money in your account to cover the payments.

Automatic payments are found on your bank and credit card statements. They could be services that you no longer use for which the company is still withdrawing money from your account. It could be a donation to a non-profit organization or political cause that you no longer support.

To stop automatic payments, call the organization to cancel the service or end the contribution. If you have cancelled such a service, check your statements each month to verify that the payment has stopped. I worked with one individual who had cancelled a service six months prior, but the company was still charging a monthly payment to her credit card. Over those six months, she paid \$60 for a service she was not using.

It is worth spending time reviewing bank and credit card statements to look for money leaks. Then you can take steps to plug those leaks. This is found cash! Use it for savings or the things on which you do want to spend money.

Robyn Young is owner of Money Care, LLC, a daily money management service in Williston, Vermont. She can be reached at www.moneycarevt.com or telephone 802-343-0389.