The New Three-Legged Stool ....Update

February 2010

Volume 1 Issue 7

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Explaining the Pro-Rata Rule for Roth Conversions

If you had been following my advice for the last couple of years, you would have been making annual non-deductible IRA contributions. Now you are ready to convert those IRAs to a Roth IRA. These non-deductible *contributions* you made to an IRA represent after-tax money. Any deductible contributions you made plus earnings in all IRA accounts represent pre-tax money. How these funds are accounted for in the event of a partial Roth conversion is referred to as the pro-rata rule.

The formula for the pro-rata calculation is – the total after-tax money in ***all*** IRAs divided by total value of ***all*** IRAs multiplied by the amount converted. Let's suppose that you made three $5,000 *non-deductible* contributions to an IRA over the past couple of years (a total of $15,000). That IRA is now worth $20,000, including growth. You also have an IRA Rollover account that is worth $80,000.

When you convert the $20,000 IRA to a Roth, $3,000 will be considered after-tax and $17,000 will be considered pre-tax. ($100,000 divided by $15,000 = 15%; $20,000 x 15% = 3,000) Even though you only made after-tax contributions to the $20,000 IRA, the IRS says you have to consider the value of all IRAs to determine the pro-rata portion that is after-tax. In this example, the IRA rollover now has $12,000 in after-tax money.

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Retiring Today – What does it mean to you?

I had been working with Ed for four years when he announced in the spring of 2008 that he was finally ready to retire. He told me he would be ready to hang it up at the end of the year. Never mind the fact that he had made the same proclamation each of the three years before. This time was it. Unfortunately, the unfolding financial crisis gave Ed another good excuse to delay retirement, even though I assured him he could easily afford to retire. Now, two years later, Ed says this year is it. Will he actually retire in 2010 or will Ed find another excuse to put it off?

Adjusting to retirement is often difficult. According to a poll done by American Demographics®, 41% of retired workers said they were having a difficult time adjusting to retirement … compared to only 12% of the recently married having a difficult time adjusting to marriage!

From a financial perspective, retirement is really pretty simple. The numbers either work or they don't. But reaching the mindset of being retired is something altogether different and in some ways, much more difficult.

Retirement is really a three-phase process.

The first phase occurs between 50 and 61 when the kids leave and our focus becomes wealth accumulation. At this time we

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Explaining the Pro-Rata Rule for Roth Conversions *(continued from page 1)*

To make things even trickier, you can't calculate the exact pro-rata percentage until the end of 2010. The total value of your IRAs used in the pro-rata rule includes the account values *as of December 31, 2010* for all conversions done during the calendar year of 2010. Any growth (or loss) in the funds remaining in your IRA from now to the end of the year will have an impact on the pro-rata calculation. This is one reason that I recommend in ***The New Three-Legged Stool*** that you allocate your fixed income investments to the IRA and equity investments to your Roth IRA and taxable accounts. For most investors the change in value will not be that significant but it is important to be aware of when planning your taxes for 2010 (or 2011 and 2012 if you choose to defer the income).

A much more significant impact from this rule comes to those who decide to rollover a 401(k) or other type of company plan. Only the total value of IRA accounts is used in the pro-rata rule. 401(k) plan values, 403(b) plans and profit sharing plans are not included in the pro-rata formula. The value of one of these type of accounts would be included if you decided to rollover the plan assets to an IRA during the year.

Let's go back to my example of the $20,000 Roth conversion. If you decided to rollover a $400,000 401(k) plan to an IRA this year, the value of that plan will now be included in the formula because it will be in an IRA on December 31, 2010. That means that only $600 of the $20,000 Roth conversion will now be considered after-tax. ($15,000 after-tax divided by $500,000 total IRA assets = 3%. 3% times the $20,000 amount converted = $600). This is very important to keep in mind when doing a rollover in the same year as a Roth conversion if after-tax money is involved.

Finally, SEP IRA values and SIMPLE IRA values are included in the definition of all IRAs. Even though these types of accounts are company sponsored they must be included in the pro-rata calculation.

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The New Three-Legged Stool

A Tax Efficient Approach to Retirement Planning
By Rick Rodgers

Imagine you're playing a game called Retirement Distribution. Your opponent, the IRS, wrote the rules of the game. The secret to winning this game is to keep the IRS out of your financial affairs before they have the right to interfere. To win, you will need a guide to the fine print in the rule book, and a sound strategy.

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Retiring Today – What does it mean to you? *(continued from page 1)*

concentrate on building the nest egg, paying off education bills, and thinking about where and how we wish to live the final third of our life. Our investment focus is usually growth-oriented.

The next phase extends from age 62 to 75. Real change begins as we leave the work life behind but not necessarily abandoned. At this point we begin to trade leisure time for human capital … the latter defined as the present value of future earnings. This is probably the most misunderstood phase of retirement … because to retire does not simply mean quitting work. It is more about the choices we make for the use of our time. For this reason I try to avoid referring to this as retirement. I like to call it financial independence.

A study done by the Gallup® organization found that 60% of retirees want to become entrepreneurs or to seek a new job to fulfill their dreams, 10% are seeking a new work-life balance, 15% hope to enjoy a traditional retirement and the remaining 15% do not want to retire. Clearly this phase is not about quitting work … more like having the freedom to do what we want, without having the economics of the endeavor as the chief motivating factor.

From an investment perspective, those who continue to work and earn, at whatever they choose to do, are continuing to build human capital and can continue with a growth oriented portfolio. As their production of human capital tapers off, and the need to depend upon investments for support of other retirement goals increases, their portfolio can gradually take on more fixed income investments.

The third and final phase of retirement begins about age 75. Now health concerns manifest themselves and we cut down on expensive travel and recreation that we pursued with such abandon 10 years before. The need for more income from investments may increase but this does not mean that we throw out all stocks in favor of fixed income. Inflation is the greatest enemy of a retiree and equity investments can be a great way to fight inflation.

A person's life, as with all things in nature, has seasons. Your investment strategy should reflect seasons as well.

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Roth Conversions and RMDs

IRA owners over the age of 70 ½ got a break for tax year 2009 when the government allowed a respite from taking a mandatory distribution from their IRA known as the Required Minimum Distribution (RMD). That break was not extended to 2010 so individual IRA owners over 70 1/2 and those that reach the age of 70 1/2 in 2010 must begin taking the RMD again. However, Roth IRAs are not subject to RMD rules. Retirees that do not need money from their IRA to support their lifestyle may consider converting their IRA to a Roth to avoid RMDs. Those considering a conversion must remember that the amount of the current year RMD is *not* eligible for conversion to a Roth.

The first dollars taken from an IRA after you reach age 70 ½ are deemed by the IRS as going toward the RMD. Therefore, you must distribute the amount of the RMD before the rest of your IRA is converted to a Roth. Failure to do so could result in an excess contribution to a Roth IRA. The IRS levies a 6% penalty for each year this money remains in the Roth IRA.

The pro-rata rule applies to RMDs in the same way we calculated it for Roth conversions. Let's say that the IRA owner in my earlier example was over 70 ½ and had to take a $3,000 RMD before converting $20,000 to a Roth. 15% of the RMD ($450) is considered after-tax and 15% of the Roth conversion ($3,000) is after-tax.

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Rick's Tip - Paying Tax on a Roth Conversion

The financial press has written a lot about Roth conversions in the past couple of months. A frequent theme of these articles is who should convert and is typically followed by a few bullet points of conditions. This list of conditions usually includes the ability to pay the tax from funds outside of the amount being converted. This is generally a good rule. But like all good rules, it does not necessarily apply to everyone.

What makes a Roth conversion a good decision is generally 1) how long will the money be in the Roth growing tax free? The longer it stays in the Roth, the more advantageous the conversion. 2) Can you convert the money in a lower tax bracket today than you expect to be in future years? Paying 15% tax today on a Roth conversion beats paying 25% later when you have to start taking RMDs.

You should consult a tax advisor or financial planner if you are considering a Roth conversion but will have to pay the taxes from part of the conversion. There could be other ways to satisfy the tax. You may also opt to defer the income from the conversion into 2011 or 2012 to give you time to accumulate the money to pay the tax.

A very important trap to keep in mind if you are considering paying the tax from the amount converted is your age. While Roth conversions are not subject to the 10% penalty if you are under age 59 ½, money withheld to pay taxes from an IRA is considered a distribution which is subject to the 10% early withdrawal penalty.

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