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In this Issue

The Market

Roth Conversion

The Market

What is next for the market? With a gain of 59% since March 6, a further gain will be increasingly difficult to get. The outlook for October is for the market to go down. [Prof Jeremy Siegel](#) however thinks "that the basic trends that are pushing equity markets higher are still in place."

US August official unemployment at 9.6% (total 17%) is still high. July unemployment Puerto Rico 16.5%, Michigan 15.9%, Nebraska 12.7%, California 12.1%, and NY 8.6%. Teenage unemployment is 21.3%.

American personal income was flat in July. American businesses reported 2Q profit margins fell 2.9%. Other economic data released in September were definitely on the weak side.

The US debt is now \$12 trillion. Politicians will find inflation more acceptable than an increase in taxes. The dollar is still falling. The greenback will set new lows.

Currencies: September, Japan up 1.4%, Switzerland 3.2%, Euro 5.6%, China 0.1%, Mexico -1.1%, Britain -1.6%, US\$ -2%.

Asset Classes: September S&P Sml Cap Pure Value up 9%, RAFI US 1500 Sml Mid 8%, Sml Grw 6%, Micro 6%, Mid Val 6%, Mid Grw 6%, Sml Val 5%, Lrg Grw 4%, RAFI US 1000 4%.

Sectors: September, Glb Solar Energy up 16%, Gold Miners 15%, Metal Mining 12%, Steel 12%, Oil Eqp & Srv 12%, Silver 12%, Cns Gds 11%, Coal 11%, Clean Enrg 10%, Semicond 10%, Ntrl Gas 10%, Listed Priv Eqty 8%, Gaming 8%, Ntrl Res 8%, Real Est 7%, Tech 6%, Gold 6%, Lumber 3%, S/W 3%, Healthcare 1%, Agricultural Commodities -2%.

Foreign Investments: September, France up 28%, Russia 18%, Brazil 16%, S Korea 14%, Taiwan 14%, BRIC 13%, Latin Am 12%, Australia 12%, India 11%, Emrg Europe 11%, Emrg Mkts 10%, Asia-J 10%, India 10%, Canada 7%, Euro 7%, Germany 6%, World- US 5%, China 4%, United Kingdom 4%, US 4%, Mexico 3%, Japan -3%.

Fixed Income: September, Financial Pref up 7%, Hi Yld 7%, Pref 6%, Ntl Munis 5%, Emrg Mrkt 5%, Covrd Calls 5%, Intl Inflation Prtected 3%, Intl Treas 3%, 20+ Yr Treas 2%, Absolute Return 2%, Intrmd Term 1%, TIPS 1%, Aggregate Bond Mrkt 1%, 3 Mo TBills 1%, GNMA 0.5%.

Roth Conversion

1. Introduction

A Roth IRA is an IRA that is funded with after tax dollars. There is no requirement for the owner to withdraw funds. Withdrawals are not taxed for either the savers or their heirs. A Roth IRA conversion is the conversion of a traditional IRA (IRA) to a Roth IRA (Roth) in order to avoid future taxes by paying current taxes.

2. Eligibility for Conversion

Only taxpayers with a [Modified Adjusted Gross Income \(MAGI\)](#) of less than \$100,000 and not filing "married filing separately" returns are eligible. Current tax law eliminates the income restriction in 2010. For 2010 only, taxes at conversion [can be deferred to 2011 and 2012](#).

3. Differences Between Traditional and Roth IRAs

- Funding.** Traditional IRAs can sometimes be funded with pretax dollars. Roth IRAs are always funded with after tax dollars.
- Taxation of Withdrawals.** Withdrawals from traditional IRAs are subject to federal and state income taxes. No taxes are levied on withdrawals from a Roth by owner or beneficiary.
- [Required Minimum Distribution \(RMD\)](#).** The traditional IRA requires withdrawals after age 70½. Roths do not require withdrawal by owner but do require tax free withdrawals by beneficiaries. Designated Beneficiaries of an IRA or a Roth IRA must withdraw either over their own life or the life of the owner. [The exact rules take 45 pages to describe](#).
- Early Withdrawal Penalty.** Both IRAs and Roths have a 10% early withdrawal penalty for funds withdrawn before 59½. Roth contributions, but not earnings, can be withdrawn at any time tax free, but not penalty free. All funds (contributions and earnings) can be withdrawn from Roth IRAs after 5 yrs, tax free, but not penalty free. For both IRAs and Roths penalty free withdrawals are available after 59½, disability, or job loss. Up to \$10,000 in earnings can be withdrawn for home purchases (if no home owned in previous 2 yrs) and for education of owner, spouse, lineal ancestors and descendants.
- [Estate Taxes](#).** For IRAs the unpaid taxes are part of the estate thus making it larger. The Roth estate has been reduced by the amount of taxes paid.
- Roths are particularly advantaged if you do not withdraw for living expenses.

g. Special rules apply to US citizens having worked in foreign countries, depending on foreign laws and tax treaties.

4. Risks

- a. Tax Laws. Tax Laws can be changed at any time. A value added or consumption tax diminishes tax benefits of an IRA and a Roth IRA. Future taxes are likely to increase.
- b. Life Expectancy. A short life diminishes the benefits of a Roth.
- c. Deflation. [Deflation](#) may decrease the benefits of a Roth if taxes are not adjusted. [Inflation](#) increases benefits.

5. Benefits of Roth Conversion

The benefit of a Roth Conversion depends primarily on federal and state tax rates at time of conversion and also life expectancy of owner and beneficiaries. Before tax moneys withdrawn from an IRA, for either conversion or [cash flow requirements](#), are taxable. For comparison we use the following example.

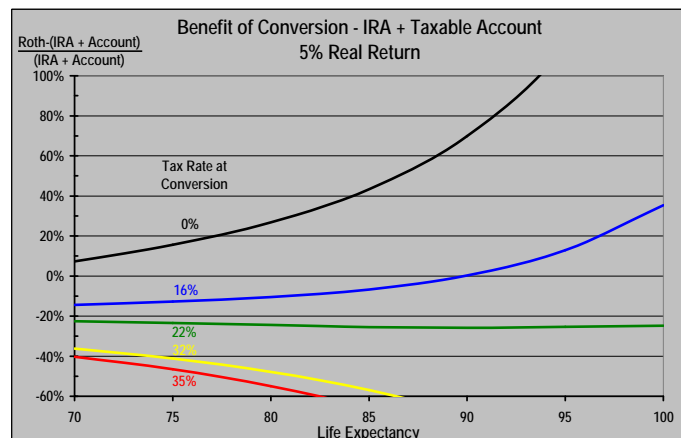
We make one conversion at age 65. Inflation is a constant 3%. The initial funding is \$1,000,000. The tax adjusted required [cash flow is 4%](#) of the initial conversion amount, or \$40,000 (about \$50,000 before taxes). Adjusting for inflation, next year's required cash flow after tax is 3% higher or \$41,200.

The tax rate is indexed by inflation so that the real tax remains the same. For example, with inflation the income is 3% higher the following year. The tax breakpoints are increased by 3% so that the tax rate on the same real income remains the same. The tax rates are the rates for joint married filers, federal taxes plus New York state taxes. At conversion, the tax rate is after deductions and exemptions. After tax IRA contributions are not taxed again.

The amount withdrawn from the IRA is the greater of the Required Minimum Distribution (RMD) or the required cash flow. If the RMD is greater then the required cash flow, the surplus is invested in a taxable account. The account has a taxable income of 2%, the income of an [S&P Exchange Traded Fund](#). The amounts withdrawn from the Roth are the required after tax cash flow. To simplify we assume there is no after-tax contribution to the IRA and all taxes are paid from the IRA funds.

6. Comparison

The following chart shows the benefit of Roth conversion as a percentage of increase in Roth assets over the total assets in the IRA & separate Taxable Account, for various marginal tax rates and various ages of death. A positive number indicates that the Roth is better.



Here is a list of assumptions used in the chart:

Amount of Conversion	\$1,000,000
Age at Conversion	65:years
Inflation	3%
Life Expectancy	Varies
Income Tax Rate at Conversion:	Varies
Future Income Tax Breakpoint:	Increased by amount of inflation
Real Investment Return	5%
Required Cash Flow After Tax	4% of initial investment adjusted for inflation & taxes
Minimum Required Distribution	2008 Uniform Lifetime Rates
Taxable Income on Taxable Investments	2%

The chart shows a benefit for Roth conversion in some cases. For example, at a marginal tax rate at conversion of 15.9% and death at 95 the Roth has a 12.8% percent advantage. The chart indicates unless your marginal income tax rate is 16% or less and your or your spouse's life expectancy is at least 90, it does not pay to convert under our assumptions (that will not all come true).

7. Bottom Line

- Conversion income limits are lifted in 2010.
- For 2010 only tax payments can be deferred to 2011 and 2012.
- Qualified distributions from a Roth are not taxable for either owner or beneficiaries.
- There are no required Roth distributions for owners.
- Beneficiaries must take distributions by using either the owner's or the beneficiaries' life expectancy.
- Consider conversion to a Roth if you are below a 16 % tax bracket and if you or your spouse has a life expectancy of at least 90 years, and the other assumptions hold for you.

I would be glad to discuss your own Roth conversion with you..

If you have questions write to curtfey@cutfey.com