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The Year of the Roth

2010 is the year of Roth. The tax rules contain special provisions for 2010 for Roth conversions. This column should give you a head start on our current thinking on the matter.

What's changed? Prior to 2010, the Adjusted Gross Income (AGI) limit for converting a traditional IRA to a Roth IRA was $100,000 (except for married filing separately). Anyone with AGI greater than that amount was prevented from converting a regular IRA to a Roth. Now, due to changes made in May 2006, taxpayers will be able to convert to a Roth IRA without regard to their AGI or filing status. Additionally, the taxable income resulting from a 2010 conversion may be spread over tax years 2011 and 2012 with half of the taxable income included in each of the two tax year.

What is special about a Roth IRA? The essential difference is that the growth in a Roth account is tax free (under current law), while the growth in a regular retirement account such as a traditional IRA, is not tax free but tax deferred. So a Roth account is one in which after tax money goes in and no tax is paid when the money comes out. That is in contrast with a regular retirement account where the money goes in before being taxed (pretax), and then is taxed when it is withdrawn from the account. There are other significant differences with a Roth account:

There are no Required Minimum Distributions (RMDs) for a Roth account. Unlike a regular retirement account which requires taxable distributions starting at age 70½, Roth account balance can be left in the account for the entire life of the account holder. Inherited Roth accounts must be distributed over the life of the beneficiary, but are still tax free. If the owner's spouse is the beneficiary, the spouse can perform a spousal rollover and treat the Roth IRA as his/her own and will not be required to take distributions during his/her lifetime.

Contributions for a Roth can continue after age 70½. Starting in 2010, a retired couple can contribute $12,000 to a Roth account, subject to the regular AGI limitations. Some commentators have suggested that, even with the AGI limitations, contributions can be made to non-deductible IRA accounts, then converted to Roth accounts. This sounds a bit like a loophole to me, and the primary concern would be whether the tax basis in distribution to fund the Roth could be based on only the non-deductible IRA or would have to be pro-rata across all IRA accounts. If the latter is the case, and the participant has large IRA or other retirement account balances, it seems to me that this "loophole" would be largely ineffective.

Distributions from a Roth are not currently included in the AGI calculation to determine the taxability of Social Security benefits. While this feature of the Roth account can confer real economic benefits, the notion of making an affirmative calculation of the benefits in a Roth conversion analysis strikes me as a bridge too far. The accumulation of assumptions and unknown variables in this regard would literally overwhelm any useful information and make the output all but meaningless. This calculation is best left to the real-time analysis of withdrawals in the years that they actually occur. This does actually raise another benefit of the Roth account, however, which is that it provides an additional source of income that can provide added flexibility in managing income during the withdrawal years.

So, how do we think about Roth accounts? Well, although the fundamental economics are indistinguishable (that is, forgoing a deduction where available is the same as prepaying taxes), we tend to think a bit differently about contributions to a Roth account versus converting existing IRA money to a Roth.

With primarily the "different buckets or sources of income" objective in mind, but also with consideration of the lack of RMDs, we see little harm in allocating a part of one's available deferral to Roth accounts. This may be done through available Roth 401(k) options or regular Roth account contributions, although most of the analysis below applies here as well.

The economics of conversion of regular IRA money to a Roth account have been the focus of much discussion and analysis. We see these as the primary salient points, in generally descending order of importance:

- If taxes (that is the account holders taxes) are expected to be lower in the withdrawal phase, conversion is not favorable. If taxes are expected to be higher during the withdrawal period, conversion may be favorable. If income tax savings are the primary consideration, this is an important point. If, for example, taxes of the participant remain unchanged, the conversion is a wash, with the big negative of prepayment of taxes.

- If the account holder is unlikely to need the funds in the IRA for consumption in their lifetime, conversion can be favorable.

- If the estate will be taxable, may be better to pay the income tax on the conversion, reduce income taxes and pass along tax free assets to heirs.

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- If the IRA assets are destined for charity, conversion would be the wrong thing to do.

- The case for conversion is much better if funds outside the IRA are available to pay the tax on the conversion. If, however, this requires a triggering of capital gains to create the liquidity for taxes, this worsens the analysis.

- IRA or other retirement plan account holders with very low tax rates (e.g., NOL's) with the expectation of higher rates in the withdrawal years may be able to take advantage of the opportunity to convert at no tax cost.

I think that the most important caveat when considering a Roth conversion is the prospect of adverse changes in the tax code. While it's not unreasonable to expect income taxes to go up, it may also be the case that the tax free aspect of the Roth could be eliminated or impaired, or that the exclusion of Roth income from the calculation of tax on Social Security income could be eliminated or impaired. Before 1984, Social Security income was not taxed at all, and in 1993 the portion of SS income subject to tax was increased from 50% to 85%. I'm just saying …

There is clearly a good bit of hype surrounding the opportunity to do a Roth conversion. Much of it is marketing and one size does not fit all. We expect to have quite a few conversations about Roth accounts s this year. If you or a friend or colleague would like to discuss this issue with us, please give us a call.

We continue to accept new clients and we sincerely appreciate your referrals.

Market Review

The table below shows the returns through December 31st, 2009 for selected basic investment asset classes. In most cases, the results below are appropriate benchmarks for the related mutual funds in your investment portfolio.

Asset Class Performance

Asset Class	Index or Proxy[1]	Last 3 Months	Last 12 Months	Peer Group Mstar Category or Average[2]	Last 3 Months	Last 12 Months
US Core Equity 1 & 2	Russell 3000	5.9	28.34	US Core Blend	5.32	28.92
US Vector Equity	Russell 2500	5.08	34.39	US Vector Blend	4.58	28.00
Int'l Core/Vector Equity	MSCI World Ex U.S.	2.44	33.67	Int'l Core & Vector Blend	2.02	36.18
Ultrashort Bonds – Corp.	3-month Treasury Bill	.02	.16	Cat: Ultrashort Bond	.94	6.67
Short Term Bonds - Municipal	Barcap 2-4 Yr Municipal	.80	5.78	Cat: Muni National Short	.26	5.91
Short Term Bonds – Gov't.	Barcap 1-5 Yr Government	-.01	.98	Cat: Short Government	.22	3.29
Short Term Bonds – Corp.	Barcap 1-5 Yr Govt/Credit	.43	4.62	Cat: Short-Term Bond	1.11	9.30
Intermediate Term Muni. Bonds	Barcap 10-Yr Municipal	-1.27	9.86	Cat: Muni National Interm	-.82	11.41
Intermediate Term Bonds – Gov't	Barcap IT Govt	-.42	-.33	Cat: Interm. Government	.14	4.74
Intermediate Term Bonds – Corp.	Barcap IT Credit	1.61	15.93	Cat: Interm-Term Bond	1.19	13.97
Global Bonds	Citigroup World Govt	-1.93	2.55	Cat: World Bond	.23	13.12
Domestic Large Cap Core	S&P 500 TR	6.04	26.46	Cat: Large Blend	5.49	28.17
Domestic Large Cap Growth	S&P 500/Citigroup Growth	7.76	31.57	Cat: Large Growth	6.68	35.68
Domestic Large Cap Value	S&P 500/Citigroup Value	4.22	21.18	Cat: Large Value	4.83	24.13
Domestic Small Cap Core	S&P 600 TR	5.12	25.57	Cat: Small Blend	4.64	31.80
Domestic Small Cap Growth	Russell 2000	3.88	27.17	Cat: Small Growth	4.79	35.46
	S&P 600/Citigroup Growth	5.81	28.35			
Domestic Small Cap Value	S&P 600/Citigroup Value	4.42	22.85	Cat: Small Value	4.00	31.32
Real Estate Investment Trusts	FTSE NAREIT-Equity	9.39	27.99	Cat: Specialty Real Estate	8.76	31.26
Int'l Large Cap Core	MSCI EAFE	2.18	31.78	Cat: Foreign Large Blend	2.64	31.24
Int'l Large Cap Value	MSCI World ex U.S.	2.44	33.67	Cat: Foreign Large Value	1.42	30.33
	MSCI EAFE Value	.28	34.23			
Int'l Small Cap Core	MSCI EAFE Small Cap	-1.03	46.78	Avg: Foreign Small Blend	1.96	56.66
Int'l Small Cap Value	DFA Int'l Small Cap Value	-1.97	39.51	Avg: Foreign Small Value	1.48	58.17
Emerging Markets	MSCI Emerging Markets	8.25	74.50	Cat: Divers. Emerging Mkts	7.59	73.81

[1] In some cases, where published indices are not readily available, the performance of an appropriate passively managed mutual fund is used as a proxy.
[2] In cases where Morningstar does not provide meaningful category data, we extract averages from the fund database to use for performance tracking and comparison.

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