

# Quarterly Newsletter

---

Creative Financial Services-Korbitz Financial Advisors LLC

Fourth Quarter 2009

---

## Introduction

The fourth quarter finished the year with positive numbers, continuing the trend that began in March. It was a relief to have recovered much of what was lost in 2008 and early 2009. The stock markets have had a bit of a rough time so far in 2010, with the uncertainty in Congress casting doubt on some of the conventional wisdom about what legislation would come out of Congress. Interest rates continue to be at near record lows. Interest rates will rise. It is just a matter of when. The other question is whether or not we will see inflation, and how bad that might be. Inflation-protected bonds are one way to hedge against this potential risk. Reducing your exposure to long-term bonds can also protect your principal when interest rates rise. I have been discussing both issues with clients in update sessions.

The hot financial topic of the year seems to be Roth IRA conversions. I wrote about this topic in my last newsletter, and have decided to expand upon and elaborate on the topic again in this newsletter. I have heard several speakers, including nationally known experts in the field, talk about this subject. I have read numerous articles and done my own analysis as well. I have reached some general conclusions about Roth IRA conversions, and want to share them with you. That is the second article below, which comprises the bulk of this newsletter.

The final article below is one on saving money. I am continuing the series I began last newsletter with an idea that you may be able to use to save money. The article this month discusses the Focus on Energy program which can provide cash rebates on various appliance and other purchases.

I wish you the best for the New Year!

*The Newsletter is provided quarterly to our clients and friends. The intent is to share some interesting views, research and items of interest.*

### **CREATIVE FINANCIAL SERVICES**

Korbitz Financial Advisors LLC  
700 Pilgrim Pkwy., Suite 300  
Elm Grove, WI 53122

**Eric S. Korbitz, CPA, CFP®**  
**262-780-0870**

[www.CFSFeeOnly.com](http://www.CFSFeeOnly.com)

I have attached three articles for your information and reading:

1. [Fourth Quarter 2009 Benchmark Analysis](#)
2. [Roth IRA Conversions](#)
3. [Saving Money-Focus on Energy Rebates](#)

## 1. Fourth Quarter 2009 Benchmark Analysis

### From Advisors Intelligence

*January 2010*

## Quarterly Investment Commentary

When the dust settled on one of the most eventful years in memory, investors had generous gains in stocks and certain segments of the bond market to salve the wounds of a disastrous 2008 and first quarter of 2009. Stocks finished the year strongly, continuing their powerful run that began in early March. Large-cap stocks, based on the Vanguard 500 Index Fund, gained about 6% in the final quarter, and finished 2009 with a 26.5% gain. In both the quarter and the full year, growth sharply outpaced value, but between larger-caps and smaller-caps, returns were pretty similar. Midcaps were a different story; while the iShares Russell Midcap ETF posted fourth-quarter returns in line with the overall market, full-year returns were just above 40%.

On the domestic fixed-income side, returns varied widely in 2009. The Vanguard Total Bond Market Index Fund gained 5.9% for the year, but the iShares Barclays 7-10 Year Treasury ETF was down 6.4% and the iShares Barclays Credit Bond ETF gained more than 14%. High-yield bonds, which normally exhibit hybrid characteristics of stocks and bonds, instead crushed both, with Merrill Lynch U.S. High-Yield Cash Pay Index gaining 56% for the year.

<b>December Benchmark Returns (Preliminary)</b>			
<b>Large-Cap Benchmarks</b>	<b>Dec</b>	<b>4Q</b>	<b>YTD</b>
Vanguard 500 Index	2.0%	6.0%	26.5%
Russell 1000 iShares	2.4%	6.0%	28.3%
Russell 1000 Growth iShares	3.1%	7.9%	36.9%
Russell 1000 Value iShares	1.8%	4.2%	19.6%
<b>Mid-Cap Benchmarks</b>			
Russell Midcap iShares	5.7%	5.9%	40.3%
Russell Midcap Growth iShares	6.2%	6.6%	46.0%
Russell Midcap Value iShares	5.2%	5.2%	34.0%
<b>Small-Cap Benchmarks</b>			
Russell 2000 iShares	8.0%	3.8%	27.1%
Russell 2000 Growth iShares	8.5%	4.1%	34.4%
Russell 2000 Value iShares	7.6%	3.6%	20.4%
<b>Other Benchmarks</b>			
Vanguard Total Int'l Stock Index	1.5%	3.2%	36.7%
Vanguard Emerging Mkt Stock Index	3.6%	8.2%	76.0%
Vanguard REIT Index	7.0%	9.1%	29.6%
Vanguard Total Bond Mkt Index	-1.7%	0.1%	5.9%
Merrill U.S. High Yield Cash Pay	3.0%	5.8%	56.3%
Barclays 7 Yr Muni Bond Index	-0.6%	-0.6%	7.6%
Citigroup World Govt. Bond Index	-5.0%	-1.9%	2.6%
JPMorgan GBI-EM Global Div. Index	-0.4%	2.8%	22.0%
DJ-UBSCI (Commodity Futures)	2.0%	9.0%	18.9%
Barclays Credit Bond iShares	-1.1%	0.9%	14.2%
Barclays 7-10 Yr Treasury Bond iShares	-4.3%	-2.5%	-6.4%

Overseas, the story was emerging markets. Both equity and debt of emerging-markets countries left their developed-market counterparts in their dust. Vanguard's Emerging Market Stock Index Fund tacked on 8.2% in the fourth quarter to bring its full-year gain to 76%, versus a gain for the predominately developed market Vanguard Total International Stock Index of 3.2% for the quarter and a still impressive 37% for the year. For bonds the pattern was tighter but the same: emerging-markets bonds (JPMorgan GBI-EM Global Diversified Index) gained 2.8% and 22% for the quarter and year, while developed-nation sovereign bonds (Citigroup World Government Bond Index) lost 1.9% in the fourth quarter and gained only 2.6% for the year.

## 2. Roth IRA Conversions

The year 2010 may be the “Year of the Tiger” in the Chinese calendar, but it will be known as the “Year of the Roth IRA” in tax and financial planning circles. The majority of this newsletter will be devoted to the issue of Roth IRAs, particularly Roth IRA conversions.

### I. Background

#### Roth IRA Basics

**Contributions:** Roth IRA contributions are non-deductible. For 2010 Roth IRA contributions are limited to the lesser of:

- \$5,000 under age 50
- \$6,000 age 50 or older
- Earned income

Contributions are limited by Modified Adjusted Gross Income (MAGI) which in general terms is the income at the bottom of page 1 of Form 1040, adjusted by a few items. Your ability to make a Roth IRA contribution is phased out as your income increases. The 2010 Contribution Limits (phase out ranges) are:

- Married Filing Jointly                      \$167,000-\$177,000 MAGI
- Single/Head of Household                \$105,000-\$120,000 MAGI
- Married Filing Separately                \$0-\$10,000 MAGI

There are significant differences between the *contribution to* and *conversion to* a Roth IRA:

- *Contribution* is annual contribution based upon earned income
- *Conversion* is based upon converting a traditional IRA to a Roth IRA and paying tax currently on the conversion.

#### Distributions

Roth IRAs do not require minimum distributions (RMDs) at age 70 ½ as opposed to traditional IRAs, which do. In order to make distributions from a Roth IRA tax-free you must meet the required holding period of 5 years. There are no taxes or penalties on earnings if held 5 years and for withdrawals after age 59 ½, or due to death, disability or the \$10,000 first time home purchase exclusion.

#### Investment Flexibility

The ability to have investment (and tax) flexibility is important in an era of changing tax rates. By having money in each of the three main types of accounts (taxable, tax deferred, and tax free) an investor can have tax and investing flexibility. For example, an investor may want to make withdrawals from these types of accounts in the following situations:

- Tax-Deferred accounts (IRA, 401k, etc.): Since withdrawals will be taxable, it would make sense to make withdrawals from this type of account in years when the investor has a low tax bracket, or in an era when tax rates are historically low.
- Taxable accounts (savings acct, brokerage acct.): These accounts are generally subject only to taxation on earnings and gains, but not on withdrawals. These types of investments would be drawn upon in years when the investor is in a high tax bracket, or during an era when tax rates are historically high.
- Tax-Free accounts (Roth IRA): Due to the great advantages of these accounts, they would generally be drawn upon last. They provide a great asset to leave to heirs, or a place of last resort to get money since it can be withdrawn tax-free. Alternatively an investor may decide to draw from these accounts during periods of high taxes or as a way to manage taxable income.

### **2010 (and beyond) Conversion Opportunity**

Conversions done in 2010 and beyond are **not** limited by your Adjusted Gross Income (AGI). The conversion is available to all investors. If the conversion is done in 2010 the investor will have ½ of *converted amount* reported in 2011 and ½ of *converted amount* reported in 2012. Note that this is not the same thing as having ½ of the 2010 *tax* paid in 2011 and 2012. However, the investor may *elect* to have the converted amount (income) completely taxed in 2010. Beyond 2010 the rules are the same as the rules for 2010 (except the income deferral opportunity.)

## **II. Those Who Most likely Should NOT Consider a Roth IRA Conversion**

### **No Non-IRA Assets**

If an investor does not have funds outside of their retirement plan accounts with which to pay the tax that will be due on a conversion, they generally should not consider a Roth IRA conversion. The exception to this statement is an investor who has no non-IRA assets but also has the ability to convert without paying ANY tax (due to excess Net Operating Loss carryovers, charitable contribution carryovers, or no taxable income.)

### **Likely To Use All IRA Assets for Support During Life**

If an investor is likely to use all of their IRA assets during their lifetime for support, then they will likely be drawing relatively small amounts each year for a long period of time. This person is not likely a candidate for Roth IRA conversion, except perhaps to fill their 15% tax bracket, as discussed below.

### **The Highly Charitably Inclined**

If an investor plans to donate all their IRA assets to charity, then converting to a Roth IRA is not a good idea. IRA assets which are left to charity are not subject to income tax (estate or charity.) Therefore there is no point in paying tax on the IRA assets.

### **Don't Want to Pay Taxes Early-EVER**

If an investor has a great aversion to paying taxes any earlier than they have to, then they are not a good candidate for conversion, as a conversion will generally require the payment of Federal and state income taxes prior to distribution.

### **III. Those Who Most Likely SHOULD Consider a Roth IRA Conversion**

#### **Large Net Operating Loss or Charitable Carryovers**

If an investor has large Net Operating Loss or Charitable Contribution carryovers into 2010, they may be able to do a Roth conversion at a low tax cost. They should consider doing so.

**Temporarily Low Tax Bracket:** If an investor is in a temporarily low tax bracket, due to loss of employment, or for other reasons, a Roth conversion should be considered. The investor is likely in a position where they can convert IRA assets to a Roth IRA for a lower tax cost than they might otherwise be able to do so.

**Significant Non-Deductible IRA Contributions:** If an investor has funded a large portion of their IRAs using non-deductible contributions they may be able to convert to a Roth IRA at a lower tax cost. The reason for this is that the non-deductible (after-tax) IRA contributions will reduce the amount of gain that will be subject to tax. The rules require proration of the non-deductible contributions across all IRA assets, so the investor cannot ONLY convert non-deductible contributions unless those are the only IRA assets the investor has.

#### **Subject to Estate Tax (when it comes back)**

If an investor has a large enough estate to be subject to Federal or state estate taxes, a Roth conversion can make sense. A Roth conversion would remove from the taxable estate the amount of Federal and state income taxes that are paid on the conversion. Thus, those taxes, which would be paid eventually, will not also be subject to estate taxes.

#### **Not Likely to Use Roth Assets During Lifetime**

Investors who will never spend their Roth IRA, but rather will leave it to their heirs, are good candidates for a Roth conversion. A Roth IRA is a great estate planning tool. The beneficiary withdraws their share tax-free, over their life expectancy. Income tax on conversion is paid while the investor is living and therefore reduces the size of the estate, which can reduce any estate tax that might be payable.

#### **Investors Who Pay the Alternative Minimum Tax (AMT)**

An investor who is in AMT can take a certain amount of income at a flat 28% tax rate until they move out of AMT and back into the regular tax brackets. Taking additional income with a Roth conversion can allow these investors to make a conversion at the 28% tax rate, which may be less than their ordinary tax rate in the future.

### **IV. Factors For Everyone Else to Consider**

#### **Run the Numbers**

It is essential that you run a tax projection before doing a Roth conversion. I have run numbers for several clients and the general reaction is one of surprise at how much tax liability is created when doing a Roth conversion.

## What can be converted to a Roth IRA?

The following types of accounts can be converted to a Roth IRA, subject to certain restrictions.

- Traditional IRA
- SEP IRA
- SIMPLE IRA
- Qualified pension, profit sharing or stock bonus plan (including 401(k) plans)—generally must either have Roth option at employer or have terminated employment.
- Annuity plan
- Tax-sheltered annuity (403(b) plan)
- Governmental deferred compensation plan (457 plan)
- Note: Inherited IRAs CANNOT be converted to Roth IRAs.
- Note: Education IRAs CANNOT be converted to Roth IRAs.

### The Roth conversion decision is not all or nothing

You can convert essentially whatever amount you are comfortable with—you can convert \$5,000 or \$500,000. Another strategy is to fill the 15% or 25% tax bracket. This involves doing enough Roth conversion to fill your 15% or 25% tax bracket, depending upon your income and your view of future tax rates. I feel that getting IRA assets out at a 15% rate is a very historically low rate of tax.

### Factors to consider with a Roth IRA conversion

- What is the investor's marginal tax bracket now?
- What is the investor's estimated tax bracket in the year of normal distribution?
- Amount of room until next tax bracket?
- Does the investor have cash available to pay the income tax?
- Is the investment at a temporarily reduced value? (and thus will be taxed at conversion at the reduced value and future appreciation will be tax-free)

### How to Undo a Roth Conversion-Recharacterization

A Roth conversion is one of the few tax moves that you have the option to undo, even in the next tax year! A conversion done in 2010 can be "recharacterized" or undone up until October 15, 2011, which is the extended due date for 2010 tax returns.

If there is any doubt about whether the investor will want to keep the Roth conversion, they should:

- Make estimated payments during the tax year assuming the Roth conversion will remain in place
- Extend the tax return and not file until the earlier of:
  - When the investor decides to keep the Roth conversion
  - October 15

If the Roth IRA is recharacterized the conversion will not appear on the income tax return, and there will likely be a tax refund. If the Roth IRA is *not* recharacterized the conversion will appear as income on the income tax return.

The investor can “reconvert” after a recharacterization but they must wait until the later of the beginning of the tax year following the initial conversion or 30 days after the recharacterization to a Traditional IRA.

- i. Example 1
  1. Convert to Roth on April 1, 2010
  2. Recharacterize to Traditional on October 1, 2010
  3. Cannot Re-convert until January 1, 2011
- ii. Example 2
  1. Convert to Roth on April 1, 2010
  2. Recharacterize to Traditional on January 15, 2011
  3. Cannot Re-convert until February 15, 2011

### **Planning Techniques**

There are several different strategies that can be used when doing a Roth conversion. Several of these include:

- The Roth Segregation Strategy
  - Convert one Traditional IRA into multiple Roth IRAs, each with different investments or asset classes, such as Bonds, US Stocks, or International Stocks.
  - Review performance in September 2011.
  - Keep the Roth IRA with the best returns, and recharacterize the rest.
  - The following year, repeat the strategy
  - See notes on Undoing a Roth Conversion above
- The Tax Bracket filling strategy
  - Determine your anticipated Taxable Income
  - Determine the amount of income you can take without going into the next tax bracket
  - Convert to a Roth IRA enough money to “fill the bracket”
- The Conversion of Assets Strategy
  - The investor may not want to or be able to contribute to a Roth IRA on an annual basis, but has taxable (non-qualified) assets.
  - In this case the investor could sell taxable assets, make the annual Roth IRA contribution, and have all future appreciation tax-free.
  - Note that income taxes may be due on the sale of the non-qualified assets.

### **Other Issues and Unknowns**

Wisconsin Law: As of now Wisconsin has not adopted P.L. 109 222 concerning Roth IRA conversions. Therefore, unless Wisconsin adopts this law:

- Early withdrawal penalties will apply to investors under 59 ½ with MAGI over \$100,000 doing a conversion in 2010 (penalty is 3.33%)
- Excess contribution penalties will apply to the Roth IRA which was improperly funded (for WI purposes) and will be subject to a 2% annual penalty until withdrawn.
- Conversions done in 2010 will be fully taxable in 2010 for Wisconsin purposes.

The legislature was scheduled to address this issue the week of January 18<sup>th</sup>. I feel that Wisconsin will conform to and adopt the Federal rules for 2010. If they do not, an investor can simply recharacterize all Roth conversions that would be subject to Wisconsin penalties. Thus, I would not hold off on doing a Roth conversion if the only issue is the Wisconsin law.

## **Conclusion**

The conversion of an IRA to a Roth IRA has been the subject of many articles in the past few months. The decision to convert to a Roth IRA is not right for everyone, nor is it appropriate for everyone who does a Roth conversion to convert all IRA assets to a Roth IRA. The investor must look at all the facts and circumstances surrounding their situation and determine what is right for them.

## **3. Saving Money—Focus on Energy Rebates**

This article is intended to provide you with an idea you can act upon to save yourself some money, if you are in the market for a new furnace, air conditioner or appliance.

You may be familiar with some of the energy saving tax credits that are available on your Federal income tax return. There is also a rebate program in Wisconsin which can also help you to decrease the cost of a new furnace, air conditioner, or major appliance.

For example, in Milwaukee County there are rebates of \$50-150 for different types of new water heaters, rebates of \$25-100 for dishwashers, clothes washers, refrigerators and freezers.

The focus on energy website is <http://www.focusonenergy.com/Default.aspx>

Click on the “Residential Programs” tab to learn more about residential programs or go to the “Find Products/Services Verify Eligibility” to see what specific programs are available to you. The programs available to each person are based upon the utility which supplies energy to you.

If you are in the market for any type of appliance, or for other energy saving items such as lighting or insulation, I urge you to check the Focus on Energy site, or with your local utility, to see if they will help pay for your purchase.

*Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by Korbitz Financial Advisors LLC with permission. Reproduction or distribution of this material is prohibited and all rights are reserved.*

---

Factual material is obtained from sources believed to be reliable, but the publisher is not responsible for any errors or omissions, or for the results of actions taken based on the information contained herein. Please call Eric Korbitz, CPA, CFP® at 262-780-0870 for a consultation. Copyright 2003-2010, Korbitz Financial Advisors LLC. All rights reserved.