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What Are The Key Factors For A Roth Conversion?

Ever since the Roth IRA was introduced—way back in 1998—financial planners have been bombarded with questions about this retirement planning tool. Can I covert a traditional IRA to a Roth? If I can, should I? And if it is a good idea, when should I convert?

There's no blanket answer to all of those questions. To a great extent, the decision to convert or not will depend on your particular circumstances. Still, there are several key factors for you to weigh, and general guidelines based on the current tax landscape.

If you have a traditional IRA, all of the distributions you receive (to the extent that they represent deductible contributions and earnings) will be taxed at ordinary income rates. Beginning in 2013, the top tax rate on ordinary income was raised from 35% to 39.6%. In addition, a 3.8% Medicare surtax now applies to the lesser of your "net investment income" (NII) or the amount of your modified adjusted gross income (MAGI) that exceeds $200,000 for single filers and $250,000 for joint filers. Although IRA distributions don't count as NII for the surtax calculation, they can still boost your annual MAGI. As a result, you might pay an effective federal income tax rate of 43.4% on all or part of your IRA distributions.

In contrast, qualified distributions from a Roth IRA that you've had for at least five years are 100% tax-free. For these purposes, "qualified distributions" include those you take after you reach age 59½; because of death or disability; or that are used for first-time homebuyer expenses (up to a lifetime limit of $10,000). For instance, if you convert a traditional IRA with $1 million in assets to a Roth IRA at age 55, you can withdraw the entire $1 million, plus any earnings, at age 60 without paying a dime in additional federal income tax. (You will already have been taxed on the amount you converted to the Roth.)

Another important distinction is that you must begin taking required minimum distributions (RMDs) from a traditional IRA after reaching age 70½; in contrast, there are no mandatory lifetime RMDs with a Roth. This can be a crucial advantage if you won't need IRA funds in retirement.

It used to be that you couldn't convert to a Roth in a year in which your MAGI exceeded $100,000. But that barrier was removed in 2010, so conversions are now available to all retirement savers.

The main stumbling block is that a conversion is taxable at ordinary income rates just as if you had withdrawn the amount as a regular distribution. That means you need to examine at least four key factors in the conversion decision.

1. The tax rate differential. Compare your current tax rate with the

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Look Out America, Here Come Millions Of Baby Boomers!

The first wave of the massive baby boom generation has reached retirement age at a time of great financial uncertainty. There were an estimated 79 million people born in the United States from 1946 through 1964, and in 2008, the oldest in that group turned 62, the earliest age of eligibility for Social Security retirement benefits. But 2008 also marked the height of the global economic crisis, and though conditions have improved since then, the economy has been growing fitfully, unemployment remains high, and home prices, which plunged during the crisis, have just begun to recover.

Against that backdrop, the question of when to begin receiving Social Security income has become more complicated—and more crucial. As recently as a decade ago, half of those who were eligible started at 62. But these days, more people are opting to delay their benefits. Waiting until full retirement age—66 for those born from 1943 through '54—means higher monthly payments, which can be increased further by waiting until as late as age 70 to claim benefits. Getting a bigger check can be particularly helpful for today's retirees, whose longer life expectancies increase the odds that they will outlive their assets.

Making the right decisions about Social Security and other retirement issues has never been more important. We can help you take stock of your situation.

Robert Pyle & Sarah Heller

It's A Question Of Proper Balance

Do you tend to put off certain chores—maybe cleaning the gutters, organizing your files, or changing batteries in smoke detectors? Most people can add another item to their to-do list: rebalancing a portfolio. However, unlike neglecting some of the others, failing to rebalance could result in significant financial losses.

Why do you have to rebalance in the first place? If you keep your holdings intact without making any changes, your preferred asset allocation will eventually get out of kilter. As a result, you could be exposing yourself to considerably more risk than you expect or consider acceptable.

Let's say you've determined the optimal approach for your current needs is to maintain a portfolio with 50% allocated to stocks, 30% to bonds, and 20% to cash and other vehicles. (This is a purely hypothetical example and not indicative of any specific portfolio.) If the value of your stocks has increased during the past year, your portfolio might now have 75% in stocks, 15% in bonds, and 10% in cash and other investments. Stocks are historically more volatile than other assets, and with that heavier concentration, you may not feel comfortable with your risk exposure. To get back to your previous allocation you could sell some shares and put the proceeds into bonds and cash.

Similarly, if the value of your stocks has declined so that they represent only 35% of your portfolio, you may want to convert some of your other holdings into stocks.

There are several other direct and indirect reasons for rebalancing. Consider these three:

• It encourages you to cash in profits from investments that have done well and shift those funds to other investments that have merit but have yet to increase in value.

• It gives you the opportunity to review the mutual funds in your portfolio to see whether they're still performing up to your expectations.

• It can smooth out investment returns. All asset classes are cyclical, so rebalancing removes some of the inherent volatility associated with investing.

How often should you rebalance? For many investors, it makes sense to do it twice a year to keep a portfolio on track. Certainly, you should rebalance at least once a year. Another approach is to rebalance whenever an asset class deviates from its target percentage by a specific amount—perhaps five percentage points. For example, a portfolio with a 50% target allocation in stocks, would be rebalanced any time the value rises to 55% or sinks to 45%.

Rebalancing is an important part of long-term investment management. It ensures that you are buying asset classes when they drop in value and don't overweight investments that have appreciated. Over a long period, it can make a major difference in a portfolio's performance and risk exposure. In addition, rebalancing can be managed for tax efficiency. Our firm handles rebalancing for clients we work with. ●

Dust Off Life Insurance Policies

When was the last time you reviewed your life insurance policies? If you're like most people, you've probably stashed your policies in a drawer, filing cabinet, or safe deposit box where they've been gathering dust. But you should review your policies periodically to see whether they still meet your needs. Depending on the outcome, you might adjust your coverage.

In particular, you should examine your policy if you've experienced one or more major "life events" during the past year. What sort of events are we talking about?

• There may have been a birth, death, or disability in the family.

• You got married, divorced, or separated.

• You bought or sold a principal residence, vacation home, or other real estate property.

• Your child completed college or graduate school.

• You acquired property as a joint tenant.

• You have switched jobs, retired, or started up a new business.

• There was a significant economic change affecting your business operation.

• You need to revise the beneficiaries of your insurance policies due to a change in circumstances.

Note that other changes that might trigger a life insurance review could be less obvious. For instance, you may need additional coverage if you're now taking on financial responsibilities for an elderly or disabled relative. Conversely, your financial responsibilities may decrease somewhat if you have finished paying off a home.

Furthermore, you should try to view your family's needs as if you were buying life insurance for the first time. It's your current and future circumstances that are the critical factors—not how things were last year

7 Major Tax Changes In The Fiscal Cliff Law

From the edge of the "fiscal cliff," Congress took a step back and approved the American Taxpayer Relief Act (ATRA), a hodgepodge of tax extensions and modifications. But the agreement postponed decisions on spending cuts and failed to continue a 2% "payroll tax holiday" for employees. Moreover, upper-income taxpayers will have to shoulder a greater burden going forward. Here are seven noteworthy changes for individuals.

1. Individual Tax Rates. Across-the-board tax hikes are averted and the "marriage penalty" is eased. Nevertheless, ATRA creates an "extra" top tax rate of 39.6% for single-filers with income above $400,000 and joint-filers with income above $450,000. When you add in the new 3.8% Medicare surtax for certain upper-income investors, which begins in 2013, your effective top tax rate can reach 43.4%!

2. Capital Gains And Dividends. The "Bush tax cuts" for capital gains and dividends are generally preserved. The maximum tax rate remains 15% for net long-term capital gain and qualified dividends (0% for investors in the lowest tax bracket). Otherwise, the tax rate for capital gains would have soared to 20% (10% for investors in the lowest tax bracket). Even worse, dividends would have been taxed at ordinary income rates. But the upper crust still pays a steep price: a maximum 20% tax applies to single-filers with income above $400,000 and joint-filers with income of more than $450,000.

3. Alternative Minimum Tax. The onerous alternative minimum tax (AMT), which has steadily been casting a wider net each year, is overhauled. Under ATRA, exemption amounts have been increased and nonrefundable personal credits can be used to offset AMT liability in full. In addition, the exemption amounts will be indexed for inflation in the future. Because the changes are retroactive to the 2012 tax year, it's been estimated they will save as many as 60 million taxpayers from the clutches of the AMT.

4. Itemized Deductions And Personal Exemptions. Two other "back-door" tax increases may affect taxes of wealthier individuals. Due to the revival of the "Pease rule," most itemized deductions are reduced by 3% of the amount of adjusted gross income (AGI) above a specified threshold, beginning in 2013 (but the overall reduction can't exceed 80%). At least ATRA establishes higher thresholds of $250,000 for single-filers and $300,000 for joint-filers. A comparable provision begins to phase out the tax benefits of personal exemptions at the same thresholds.

5. Education Tax Breaks. ATRA generally extends several valuable tax incentives relating to higher education. Significantly, it allows parents to claim the maximum $2,500 American Opportunity Tax Credit (AOTC) for another five years, subject to a phaseout based on modified adjusted gross income (MAGI). It also extends the above-the-line deduction for tuition and fees, also phased out based on MAGI, through 2013. This deduction may be claimed in lieu of a higher education credit. The tuition deduction extension is retroactive to 2012. Finally, ATRA permanently extends enhancements for Coverdell Education Savings Accounts (CESAs), the tax exclusion for employer-provided education assistance and the student loan interest deduction.

6. Extensions Of Other Rules. Besides those already mentioned, ATRA extends a host of other tax provisions for individuals, many of them retroactive to the beginning of 2012 (i.e., for provisions that technically expired). Most of the extended tax breaks are limited by dollar amounts. This includes:

- Optional state sales tax deduction (in lieu of state income tax)
- Enhanced child tax credit, dependent care credit and adoption credit (and tax exclusion for adoption program assistance)
- Credit for energy-saving at home
- Monthly tax exclusion for certain commuting benefits
- Deduction for mortgage insurance premiums
- Deduction for classroom expenses of educators
- Tax exclusion for mortgage debt forgiveness
- Tax benefits for donating real estate for conservation purposes
- Tax-free distributions of IRA funds to charity by those age 70 ½ or over

7. Estate And Gift Taxes. At long last, there's greater certainty in estate planning. Beginning in 2013, the unified estate and gift tax system permanently retains a $5 million exemption and will be indexed annually for inflation ($5.25 million in 2013), instead of plummeting from $5.12 million in 2012 to $1 million. The top estate tax rate, which was scheduled to jump from 35% in 2012 to 55% in 2013, is bumped up to 40%. ATRA also retains the provision allowing "portability" of estate tax exemptions between spouses and coordinates various other aspects, including implementation of the generation-skipping tax.

These are just some of the highlights of the fiscal cliff law. We will be offering further guidance on the tax law changes, but please don't hesitate to call us about how the changes affect you personally. ●

or several years before. And don't forget to review all of your life insurance policies, including any group coverage that your employer (and your spouse's employer) might be providing.

Needless to say, this is an on-going process. A main function of life insurance is to replace lost income that your family relies on if you should die prematurely. When your financial obligations are small, the amount of life insurance coverage you require is also small. However, as those obligations grow, so does your need to acquire more coverage.

Typically, your life insurance needs will be at their greatest when your children are relatively young and you're in the midst of your career. Once your children have flown the coop, or you have retired, your insurance needs will likely not be as great.

Best approach: Assess your life insurance needs at regular intervals. You may want to do so at the start of a new year or on some other "anniversary" date. In any event, don't let too much time go by without a regular check-up. ●

Pros and Cons Of Section 529 Plans

A Section 529 college savings plan can be a tax-smart way to help your children pay for their higher education. But you should also be aware of several potential pitfalls of this planning device. Here's a brief rundown on the main pros and cons.

The Pros

The account can make money. A Section 529 plan works much like a mutual fund, with account assets typically invested in equities by professional money managers. They do the hard work while you sit back and watch the account grow.

Count on the tax benefits. Contributions to the plan are gift-tax-free, the earnings within the plan are income-tax-free and any distributions that are used for qualified education expenses are also income-tax-free. That's a hard combination to beat.

Funds may be invested automatically. Frequently, a plan will let you have funds automatically withdrawn from your checking or savings account. Not only is this convenient, it also takes some of the guesswork out of saving for college.

Contribution limits are generous. State law effectively controls the amount you can sock away in a Section 529 plan, but the limits are favorable. In some states, you can contribute as much as $200,000 to your child's account, which should be sufficient to cover tuition for four years at most schools.

Account assets are portable. Although 529 plans are sponsored by individual states, the money can be used to pay for college wherever your child attends. Also, if funds are left over when your son or daughter completes school, you can use the excess to pay college expenses for another child. You don't have to close the account until the youngest child reaches age 30.

The Cons

Funds must be used to pay qualified expenses. If you make a withdrawal and use the cash for any other reason—say, to pay emergency medical expenses—the distribution attributable to earnings is taxed on both federal and state levels, and you'll owe a 10% penalty. You'll also be taxed on any leftover amount you receive after closing the account.

The investments are out of your hands. This is the flip side of having professional money management. If you're a savvy investor, you may prefer to have greater control over the funds. Should you be inclined to use a different investment option outside of a 529 you've established, you'll be taxed and penalized if you withdraw funds and invest them elsewhere.

It might affect financial aid eligibility. The impact of a Section 529 plan is usually negligible if held by a parent. Nevertheless, it must be factored into the equation to determine the "expected family contribution" (EFC) for college costs.

For most families, Section 529 plans are a good deal, but they're not for everyone. We can provide the necessary guidance. ●

The Key Factors For A Roth

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tax rate bracket you expect to be in when you withdraw funds from your IRA in retirement. The lower your current rate as compared to the expected retirement rate, the greater the incentive to convert now. Conversely, you may not want to convert if your current rate is much higher than your expected rate during retirement.

2. Availability of non-IRA funds. One frequently overlooked Roth conversion question involves whether you have funds on hand to pay a significant conversion tax. If you'll be forced to siphon funds from your IRA to pay the tax bill, you're diluting the future benefit of a conversion. But a conversion now could make sense if you have money in other accounts to cover the resulting tax.

3. Funds you have to pay living expenses. Will you need to begin drawing down IRA funds within the next few years? If you have to tap a Roth right away, you may not realize the full benefit of the tax-free distributions. If you can keep your IRA intact for a longer period, a conversion may be more attractive.

4. Time horizon. A Roth conversion may appeal most to middle-aged investors who are still several years from retirement. If retirement is imminent or you're already retired, that may reduce your incentive to make a conversion. Nevertheless, switching to a Roth may still be reasonable if you're older, especially if you're looking for ways to preserve assets for your heirs.

Focusing on these four factors, crunch the numbers to see whether a Roth makes sense for your situation. One or more factors may count more heavily for you than others do, and we can help you do a detailed analysis.

Finally: Don't worry about pulling the trigger on a conversion and then regretting your decision. You can "recharacterize" a Roth IRA as a traditional IRA if you make the decision in advance of tax return due date (plus extensions) for the year of the conversion.

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