The CJ Investment Newsletter
Callom B. Jones, V
Investment Adviser Representative

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Roth Conversions

Purpose

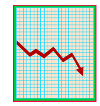
The *CJ* Investment Newsletter deals with the entire spectrum of securities investing, including cash (money market funds), bonds, equities and options. It will evaluate the overall investing environment and then discuss the relative allocations of these asset types, as well as strategies to implement within them. Essentially, it reflects what I'm actually doing with my clients.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please call me for more information.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I think is important when investing may help you. Please contact me if you have any questions or comments. I'd love to hear your reaction to my letter.

The CJ Growth Strategy (back page) has been an ongoing aggressive growth model portfolio since 1/98. Its results continue to be tracked herein.

Quick Look

Market	**Next Expected Move**
	

- Because of the special ability of taxes on Roth conversions to be spread over 2 years expires at the end of 2010, Roth conversions will be discussed while there's still time for clients to make and implement such a decision if they so choose.
- Please note that none of the information presented here is in any way intended to convince you to convert all or part of your regular IRA's or other qualified monies to Roth status. I'm simply presenting some relevant facts in this area. You need to decide, preferably with your tax advisor, whether you wish to make any type of Roth conversion in this year or any future years.
- This is a general discussion of a highly complex tax area: another reason to get a tax advisor familiar with such things involved if you feel they may apply to you. These items do come from sources believed to be reliable and such sources will be cited when appropriate.

Roth Conversions

First of all, what is a Roth conversion? At the risk of getting too basic, it might be helpful to discuss the entities. involved:

- A "regular" IRA (IRA) is a trust created

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Trend Capital Management, LLC
9717 W 121 Terrace ▪ Overland Park, KS 66213
O (913) 897-7576 ▪ C (913) 568-9916 ▪ e TCM@TrendCapitalMgmt.com

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- *(continued)* first by the ERISA Act of 1974. The trust is a legal entity, which, in this case, is designed to hold pretax investable assets that can grow inside the trust tax-free. (*"Tax-free" means INCOME-tax-free in the following discussion, unless otherwise noted.*) When the beneficiary (you, if it's your IRA) reaches retirement age (defined by law as the year in which the beneficiary becomes 59 ½), the trust corpus (body) then can distribute assets to the beneficiary as a means of support. Presumably, the beneficiary is retired and has to live off assets accumulated through a lifetime. Upon distribution, the amounts distributed become taxable.
- A Roth IRA (Roth or Roth IRA) (named for Senator William V. Roth) was first created by the Taxpayer Relief act of 1997. It is similar to an IRA, but with some substantial differences – and advantages. The trust is funded with after-tax dollars, unlike the IRA. Like an IRA, it grows inside the trust tax-free. However, upon distribution at age 59 ½ or older AND after a 5-year minimum holding period, both the principle and the earnings (growth) in the Roth are distributed tax-free, unlike an IRA.

There are many other differences, but those cover the most basic defining characteristics of both the IRA and Roth.

A Roth Conversion is an event that transfers some or all assets contained in an IRA into a Roth IRA. Since IRA's are funded with pretax dollars, such a conversion involves the recognition of all of the amounts converted as income, which is then subject to income tax. Once converted, however, the now after-tax funds in the Roth are able to both grow and to be distributed tax-free, subject to the conditions outlined above.

So, why would someone want to convert all or part of their IRA assets to Roth assets?

In the interest of saving your time and space in this letter, here, verbatim, are the reasons for converting to a Roth that Robert S. Keebler, CPA, MST, AEP of Baker Tilly Virchow Krause, LLP of Appleton WI presented at the recent AICPA Estate and Gift Tax Conference in Washington, DC this summer. (*Italics are inserted by me. I hope that they add clarity.*) :

1. Taxpayers have special favorable tax attributes including charitable deduction carry-forwards, investment tax credits, net operating losses (NOL's), high basis non-deductable traditional IRA's, etc. *One of the primary tenets of Roth conversions is that the taxes due upon conversion be paid with taxable funds from outside of the trust corpus in order to preserve as much principle as possible. This allows a larger, income-tax-free corpus to be distributed later, at the time of the beneficiary's choosing. Having tax benefit carryforwards can reduce or eliminate the need to pay income tax on the Roth conversion.*
2. Suspension of the minimum distribution rules at age 70 ½ provides a considerable advantage to the Roth IRA holder. *You are never (so far) required to distribute assets from a Roth.*
3. Taxpayers benefit from paying income tax before estate tax (when a Roth IRA election is made) compared to the income tax deduction obtained when a traditional IRA is subject to estate tax. *This is true because, historically, estate tax rates are higher than income tax rates. A smaller deduction against a larger tax is a greater benefit than the reverse.*
4. Taxpayers who can pay the income tax on the IRA from non-IRA funds benefit greatly from the Roth IRA because of the ability to enjoy greater tax-free yields. *See Point 1.*
5. Taxpayers who need to use IRA assets to fund their Unified Credit bypass trust are well advised to consider making a Roth IRA election for that portion of their overall IRA funds.
6. Taxpayers making the Roth IRA election during their lifetime reduce their overall estate, therefore lowering the effect of higher estate tax rates. *The taxes paid reduce the size (and, therefore, the taxes paid) of the estate.*
7. Because federal tax brackets are more favorable for married couples filing joint returns than for single individuals, Roth IRA distributions won't cause an increase in tax rates for the surviving spouse when one spouse is deceased because the distributions are tax-free.
8. Post-death distributions to beneficiaries are tax-free.
9. Tax rates are expected to increase in the near future. *Like with the expiration of the Bush tax cuts at the end of 2010.*
10. The new 3.8% Medicare surtax. *Since Roth distributions are income-tax-free, they are not subject to this new, income-based surtax.*

OK. If you followed all that, YOU should be writing this article.

Back to basics. The main message to take away here is that – GENERALLY – having Roth assets is superior to having IRA assets. However, your

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Asset Allocation Percentages
CJ Current Suggested Ranges

Dow Theory Market Phase: BEAR
Appropriate Current Allocation: DEFENSIVE

Asset Class	**Conser-vative**	**Aggres-sive**
Money Market Funds	70-10%	55- 5%
Long Positions:		
Bonds & Bond Funds	30-60%	40-60%
RD Stocks	0-10%	0-10%
Growth Stocks	0%	0%
Gold Equities/Funds	0-20%	10-30%
Bear Market Funds	0- 10%	5-20%
Aggressive Positions:		
Shorts and/or Options	0%	0- 5%

Notes:
Income generating portfolios may not conform to the above guidelines. If income is the primary purpose of a portfolio, income needs are met *first*, then other allocations are made.

Up to 50% of bond/bond fund positions should be in international (non-US) bonds. I expect such bonds will provide higher interest paid on the face due to the additional *perceived* risk of foreign bonds, as well as providing hedging gains if the dollar declines against foreign currencies due to Fed monetary policies.

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specific circumstances may dictate that "generally" doesn't work for you. That's why you should consult an advisor that is familiar with ALL the rules and considerations to see what works best for you.

Again, from Keebler's presentation: "In simplest terms, a traditional IRA will produce the same after-tax result as a Roth IRA provided that:

- The annual growth rates are the same
- The tax rate in the conversion year is the same as the tax rate during the withdrawal years (i.e. A x B x C = D, A x C x B = D)"

After reviewing several scenarios, the general gist is that, *if income tax rates rise in the future and other factors remain unchanged, it is to some advantage to convert IRA assets into Roth assets*. That is, at some point in the future and after payment of all taxes from your regular IRA, your net retirement assets would be greater than if you did not convert.

If income tax rates do not rise, it may not be advantageous. Clearly, the longer the time horizon, the greater the benefit, if there is a benefit. It could be a substantial benefit for 20 – 40 year-olds. Above 50 years old, future income tax rates would have to be substantially higher to realize a significant difference. (For the sake of argument, let's define "significant difference" as more than 10% total net assets after 20 years.)

Other Considerations:

- For 2010 Roth conversions ONLY, the tax for the conversion(s) can be elected to be paid in tax years 2011 – 2012. 50% of the income/tax would be recognized and paid in each of those years.
- Income recognized because of a Roth conversion may cause "bracket creep" if a taxpayer's income is relatively close to being in a higher tax bracket. This can be mitigated somewhat by doing *partial* Roth conversions over two or more years.
- If you have significant amounts of tax preference items, income from Roth conversion(s) could make you subject to Alternative Minimum Tax. Keebler's point 1 (above) has tax preference items in it.
- *There is no current annual income limit applied to Roth conversions as there is to Roth contributions*. This opens the door for wealthy individuals to be able to realize the benefits of having Roth IRA(s). With its additional Estate tax planning benefits, Roth conversions, while expensive (taxes and professional fees), may be a significant boon to high net worth individuals and families.

Again, your situation needs to be looked at specifically by an advisor who really understands the applicable law and tax code.

Finally, it's important to consider the meaning of "all other things being equal." What's the likelihood of law and code changes in the future changing the underlying reasons for Roth conversions? Obviously, the longer the time horizon, the more likely changes become. Will the government keep its promises? What will they do if they continue to spend like drunken sailors and become (more?) desperate for tax revenue? Nancy Pelosi has already put citizens on notice that, at least for her and like-minded politicians, retirement accounts are not sacrosanct. After all, *they can decide if you really need your money*, right?

As it is with all things, there are no guarantees in life. Change alters even the best plans. All we have to work with is the circumstances as they are and then to deal with change as it occurs.