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CHECKMATE

Market Updates, Perspective, News and Context

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WHY PAY YOUR TAXES DECADES IN ADVANCE?

To Roth or Not to Roth

By Thomas K. Brueckner

If you don't have to pay your taxes *for decades*, why pay them all in one year *now?*

The "Roth Conversion" has become popular again, often as an inducement from brokerage firms claiming that taxes are certain to be higher in the future – and are thus "on sale" today. And while there are instances where a Roth conversion may make sense for certain people (at certain times of their lives); for others, taking advantage of options that exist within a traditional IRA may be more advantageous.

In looking at these products, I believe it is important to give you context as well as updated, commonly-held guidelines on whether and when you should consider converting some or all of an IRA account into a tax-free Roth IRA.

The Context: In any IRA account, the owner enjoys the benefits of what we advisors call "triple compounding."

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Quote for the Times

"One cannot use logic and reason to talk someone out of a firmly-held position, if they didn't employ logic and reason to arrive at it in the first place. Such people don't think – they feel – and will demonstrate this repeatedly if you listen closely."

- Elke Brueckner, 70, mother, grandmother and citizen

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You earn interest (or appreciation, capital gains, or dividends) on your:

- *Principal* (contributions)
- *Interest*
- *Taxes* that you would otherwise have paid that year (Money belonging to the IRS that was allowed to remain in the account, alongside your money as if yours, making you more money each year.)

Let's not understate this benefit: The IRS does not charge you interest on this "loan," they merely promise to catch up with you later. Therefore, if you started contributing to an IRA or 401(k) at 25, and did so until you retired at 65, *you would have enjoyed the interest-free use of the tax man's money for 40 years*.

It is actually even better than that. The IRS cannot make you take money out of the account taxably until April 1st of the year *after* the year in which you turn 70½. When you do so, the requirement is that you withdraw roughly 3.7 percent of your prior year-end value that first year, leaving the other 96.3 percent of your account to "triple compound" for another year. (See **"The Numbers"** for more about this).

The Numbers

Roth Conversion	Retaining IRA until age 70 ½
$1,000,000 *(Amount eligible for taxation)* x 34 percent *(Est. State and Federal Taxes)*	$1,000,000 *(Amount eligible for taxation)* x 3.7 percent *(Required 1st year distribution)*
$340,000 *(Taxes paid)*	$37,000 *(Amount eligible for taxation)* x 22 percent *(State and Federal Taxes)*
	$8,140 *(Taxes paid for first-year RMD)*
Result: $660,000 remaining as new Roth IRA	**Result:** $963,000 remaining in IRA triple compounding)

The Argument: Proponents of Roth conversion argue that, in order to avoid that $8,140 in taxes (less than 1 percent of the account value) – and deny yourself the ongoing benefit of triple compounding over the remaining 15-20 years of your life – you should instead pay your taxes on the entirety of the account as much as 20 to 30 years before they are due. This would result in an immediate loss of roughly one-third of the account ($340,000), money on which you would never earn free interest again.

However, the "good news" is that, from that point forward, your new Roth IRA would grow tax-free, not just during your lifetime, but during that of your heirs as well (if they do not spend it as found money first). *Paying $340,000 in taxes, just to avoid paying $8,140 in taxes, had better leave you with one huge other benefit in order for the entire exercise to have been worth it.*

When and Whether: So when does Roth conversion make sense, for whom, and under what circumstances? The following are updated criteria for 2012, based on calculations considerate of current tax law:

- When you do not or will not need the money for your own retirement.
- When you would rather pay *income* taxes on it at 28 to 35 percent, than have your heirs pay *estate* taxes on it at up to 55 percent. (Only applicable to net-worths in excess of $10 million.)
- When you have enough funds outside of the IRA with which to pay the *income* taxes, ideally spread out over several years.
- When the IRA owner is under 58 years of age.*
- When you are certain that you will be in a *substantially* higher tax bracket once retired, than the one you are in during the year(s) you intend to convert.
- *When you are certain that your heirs will not be tempted to touch the money for at least 10-25 years, thus giving the potential for the tax-free growth an opportunity to prove itself, on their behalf and on behalf of their heirs.*

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DO AN "IN-SERVICE ROLLOVER" AFTER 59½!

Rescuing Your 401(k) *Before* You Retire

By Thomas K. Brueckner

When they retire, most pre-retirees know they will need to move, or "roll over," their company 401(k) plan assets into an IRA (Individual Retirement Account) with their local advisor. Leaving those assets with the custodian of a former employer is rarely a good idea, and carries with it multiple pitfalls, especially potential tax disasters for one's heirs.

A common concern we hear from clients and prospects who are still working is that they wish they had better investment offerings inside their employer plan. Many complain that "the risk is too high, the performance is spotty at best, and the 'Stable Value' option or money market account/fund is currently paying yields of negative 1.2 percent per year!" Many wish they could move those 401(k) funds to safer holdings while continuing to work to 65, and *most are shocked to learn that they can usually do so after turning 59½!* However, don't expect your human resources department to know about it.

A note of caution: If the check is cut to you, you'll have 60 days to redeposit it with a new IRA custodian, lest you get taxed on the entire amount as income for that year.

The procedure is simple: Because most employer plan administrators do not accept third-party transfer forms of other brokerage firms, you will need to ask your HR department for their forms. (We often help pre-retirees who are still working complete this paperwork.) You usually have a choice as to whether you want to rescue a percentage or a specific dollar amount, and whether you want the check made payable to yourself or to your new IRA custodian.

A CASE STUDY

John and Sally, each 60, have five more years to work at the software company they both have been at for 30 years. Recently, they began contributing the maximum 15 percent of their salaries into their 401(k) plan, subject to an employer match of another 5 percent – definitely an excellent savings rate.

The Problem: John and Sally were quite unhappy with the plan's investment options available to them, finding them risk-intensive ("more suitable for younger employees"), limiting, and fee-laden. There did not appear to be many conservative options for older investors, and the money market (cash) fund was paying a meager 0.2 percent interest.

Having attended one of our recent seminars, they overheard my answer to a question on this very subject, and were intrigued to learn that the Fixed Index Annuity (FIA) we'd just introduced was available to them as a pre-retirement solution to this dilemma – with a 10 percent bonus to boot! As a result, they could have the safety and security of downside protection, and still enjoy generous market-linked interest credits amid a rising market – exactly what they wish they had as an option in their 401(k) plan.

The Solution: John and Sally stopped by HR the following week to obtain the forms for an "in-service rollover" of their accounts. Confused, the young lady behind the counter asked them if they were retiring this year. They each said, "No, we intend to work for four or five more years." It wasn't until they insisted – at our direction – that they had the right to their funds after turning 59½ that she was able to confirm this right with a phone call.

Afterward, they stopped by our office to complete the forms and, one week later, two separate checks made payable to their chosen IRA custodian, f/b/o (for benefit of) John Smith and Sally Smith, arrived in their home mailbox. They had both elected to rescue 99 percent of their plan values – leaving the other 1 percent in their accounts to keep them open to receive the following week's ongoing contribution from salary – over to the new FIA custodian that we recommended. Once we applied the funds to their new IRAs, they each received a 10 percent bonus right away, an especially nice benefit on top of the safety and guarantees they were seeking.

The Best Part: Every year, just prior to their anniversary dates with us, we will fill out those same employer plan forms again, transfer 99 percent of their then-current values for the year, and get *another* 10 percent bonus on those new funds.

The Bottom Line: John and Sally will have received the tax deduction for their 15 percent annual contributions, their employer's 5 percent match, their initial 10 percent bonus on the first roll-over, *as well as an additional 10 percent bonus for each additional rollover in the next five years before they retire*. As importantly, they will never lose money amid a stock market decline again; and in growth years, they will receive market-linked interest credits (historically 5 to 9 percent) proportional to the market's advances.

Not a bad deal compared to the lack of any such options in that old 401(k). ■

Note: These same benefits are also available with most 403(b), TSA, and 457 plans.

EYE ON THE MARKET

Will "Sell in May and Stay Away" Prove Wise Again in 2012?

By Jennie Bond

For each of the last two years, investors who got out of the stock market at the end of April would have been spared significant losses and sleepless nights in the six months that followed. This is consistent with a long-held axiom on Wall Street, "sell in May, and stay away," which was first made famous by the *Stock Trader's Almanac*.

A $10,000 investment in the S&P 500 index, made during each May-through-October period since 1950, would be worth only $6,724 today, according to the Almanac. However, that same $10,000, invested during each November-through-April period, *would have grown to an astounding $1.6 million dollars!*

We have been asked many times what we believe contributes to such a compelling seasonal anomaly, and we always pose the following question in return:

"What two events or behaviors, one taking place in mid April and the other in early November, have we engaged in for decades in this country?"

Answer: We pay our income taxes in mid-April, and we vote every other year in early-November. Think about what investors often do in October, just before the outcome of a close election that could adversely impact their accounts. Many move to cash (i.e. sell, driving the markets downward) until the election outcome is known, after which they reinvest in those sectors they believe might benefit from the intended actions of the new Congress or Administration. Six months later, investors who don't have enough cash on hand in April with which to pay the taxes on last year's gains, again liquidate (sell) some of their holdings.

Further, many employed investors make year-end or "catch-up" contributions, sometimes in anticipation of pending year-end bonuses, into their 401(k) accounts. These stock or mutual fund purchases also drive markets higher before the end of the year.

Whether this trend holds true again in 2012 remains to be seen. At this writing, the S&P 500 is down -3.6%, perhaps proving that it is hard to argue against a 62-year trend netting $1,600,000 versus $6724. ■

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It is this last caveat that is often the deal breaker. Seldom will one's heirs exercise such restraint when needs arise (college tuition, long term care of an in-law, mortgage pay-off, or a job loss after 50), or opportunities (a "sure-thing" investment, buying a business, a vacation property, boat or exotic car) present themselves. An account that grows tax-free "forever" only does its owner good if he/she does not spend most of it before forever arrives.

"…But your Mom and Dad would have *wanted* us to have this (beach house, car, toy), honey." For this you paid $340,000 in taxes decades before they were due? Sadly, in most cases: Yes.

Epilogue: What if, instead of Roth conversion, we could show you a way to double or triple that IRA for your heirs, without market risk, in about four to six weeks, entirely income tax-free to your children, grandchildren or a charity – and with no requirement that they leave it alone for decades to justify the strategy? Give Jennie or Rachel a call today to set up a phone or in-office conversation about this to see if you qualify! ■

**Cindy Creed, a Chandler-based CPA – (480) 833-6088 – with whom we have several clients in common, told us that their firm has crunched the numbers and found that Roth conversion rarely makes sense after the age of 55 – and only if the client meets the other criteria.*

Quotes from History

"Doctor Franklin, what form of government have you given us, sir?!"

"A republic, ma'am, if you can keep it…"

- Benjamin Franklin, 1787

Benjamin Franklin was replying to a constituent at the close of the Constitutional Convention in 1787. Our founders knew what many in the media, academia, and even today's Congress have forgotten: democracies always commit suicide, while a constitutional republic requires a self-disciplined and well-informed citizenry.

"A democracy can only exist until the voters discover that they can vote themselves largesse from the public treasury. From that moment on, the majority always votes for the candidates promising the most benefits, after which every democracy collapses…"

- Alexander Tyler, 1887

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