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Financial Briefs

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Plan for 2010 Roth Conversions

Starting in 2010, all taxpayers, regardless of the amount of their adjusted gross income (AGI), can convert a traditional individual retirement account (IRA) to a Roth IRA. Before 2010, your AGI cannot exceed $100,000 to convert, not including any income resulting from the conversion. Amounts converted must be included in income if taxable when withdrawn (i.e., contributions and earnings in deductible IRAs and earnings in nondeductible IRAs), but are exempt from the 10% early withdrawal penalty.

If you make a conversion in 2010, the tax can be paid in two installments in 2011 and 2012, with no tax due in 2010. However, if you prefer, you can elect to pay the tax in 2010, which may make sense if the current lower tax rates are not extended beyond 2010 or you expect much higher income in 2011 and 2012. Taxes on conversions made after 2010 must be paid in the year of conversion.

Even though this tax rule does not go into effect until 2010, you should start planning now. For instance, you should consider making the maximum IRA contributions to a nondeductible IRA in 2007, 2008, and 2009, and then convert the nondeductible IRA to a Roth IRA in 2010. The maximum IRA contribution is $4,000 in 2007 and $5,000 after that, plus an additional $1,000 catch-up contribution for taxpayers age 50 and older. After 2008, the contribution amount will be adjusted for inflation in $500 increments.

By using this strategy, you would only have to pay income taxes on earnings within the IRA because the contributions are nondeductible. However, be aware that if you also have other traditional deductible IRA funds, even in another IRA account, you cannot just convert the nondeductible IRA. You have to assume that a pro-rata portion of both the deductible and nondeductible IRA funds are being converted.

Find out whether your 401(k) plan accepts rollovers from an IRA. If it does, you could roll over your deductible IRA and earnings in your nondeductible IRA to your 401(k) plan. You would then just have nondeductible contributions remaining in your IRA, which could be rolled over to a Roth IRA without paying any income taxes. Check with your plan to see if you can later roll the funds back to an IRA.

This new conversion provision will effectively remove the income limitations for contributions to a Roth IRA after 2010. In 2007, Roth IRA contributions can be made by single taxpayers with AGI less than $99,000 (contributions are phased out with AGI between $99,000 and

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Rollovers for Nonspouse Beneficiaries Are Complicated

The Pension Protection Act of 2006 contained a provision allowing nonspouse beneficiaries to roll over funds from an employer pension plan to an inherited individual retirement account (IRA), starting in 2007. This was viewed as a significant development for nonspouse beneficiaries, since they would be able to extend distributions from employer pension plans over a longer period. However, recent guidance by the Internal Revenue Service (IRS) indicates that this provision may be difficult for nonspouse beneficiaries to implement.

Prior Law

Prior to 2007, spouses were the only beneficiaries who could make a nontaxable rollover of a deceased's interest in an employer retirement plan to an IRA. Nonspouse beneficiaries had to take taxable distributions from the plan according to the plan's terms, which typically required the entire balance to be paid out by the end of the fifth year following the decedent's death. No payouts were typically required in years one through four, but the entire balance had to be distributed by the end of year five. Income taxes

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FR2007-0322-0111

Undoing a Roth Conversion

When converting a traditional individual retirement account (IRA) to a Roth IRA, transferred amounts must be included in income if taxable when withdrawn (e.g., contributions and earnings in traditional IRAs and earnings in nondeductible IRAs), but are exempt from the 10% federal income tax penalty. Your adjusted gross income (AGI) cannot exceed $100,000 in the conversion year, excluding any converted amounts.

To use this strategy effectively, you need to decide when to convert. Taxes are paid based on your investments' values on the conversion date. If those values decline after you convert, you end up paying taxes on more than the current market value.

If you're in that situation, consider recharacterizing your conversion. For conversions made in 2007, you can recharacterize until October 15, 2008, meaning you can convert back to your original traditional IRA. Just make sure not to take possession of the funds. The transfer from the Roth IRA to the traditional IRA should be a trustee-to-trustee transfer. After the recharacterization, it is as if you did not convert, so you owe no taxes. If you already filed your 2007 tax return and paid the taxes, you can file an amended return to get a refund. You can then reconvert at a later date, provided your AGI does not exceed $100,000 in the conversion year. (Keep in mind that starting in 2010 there is no income limitation for Roth IRA conversions.) The reconversion can be completed at the later of 30 days after the recharacterization or the beginning of the tax year following the first conversion.

You can recharacterize just a portion of the conversion. However, if you have several investments in the IRA, you can't simply choose the ones with the largest losses. In that situation, a pro-rata portion of all the investments in the account will be considered in the recharacterization. You can bypass this rule by setting up separate Roth IRAs for each investment. Then, if one declines substantially, you can recharacterize that one Roth IRA account, leaving the other accounts intact.

There are other situations in which you might want to recharacterize. You might have converted to a Roth IRA, thinking your income for the year would be less than $100,000. If you later find out that your income is over that threshold, you can recharacterize the conversion. Otherwise, in addition to the income taxes due, you would also have to pay a 10% federal income tax penalty and a 6% excise tax.

You can also recharacterize annual IRA contributions. Perhaps you contributed to a traditional IRA but find your income is over the thresholds. You could recharacterize to a Roth or nondeductible IRA contribution.

Please call if you'd like to discuss recharacterizations in more detail.

2010 Roth Conversions

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$114,000) and by married couples filing jointly with AGI less than $156,000 (contributions are phased out with AGI between $156,000 and $166,000). It doesn't matter whether you participate in a company-sponsored pension plan. Starting in 2010, individuals with incomes over the limit can make contributions to a nondeductible traditional IRA and then immediately convert the balance to a Roth IRA.

There are a variety of factors that should be considered before deciding whether to convert a traditional IRA to a Roth IRA. Factors that favor converting to a Roth IRA include:

- You can pay the income taxes due from the conversion with funds outside the IRA. By doing so, you are in essence increasing your IRA's value by the tax amount.
- You expect your marginal tax rate at withdrawal to be equal to or greater than your current marginal tax rate. When your rates are equal at both times, the financial results from either IRA will be similar. Increasing income tax brackets generally makes it advantageous to convert to a Roth IRA.
- You won't make withdrawals from your Roth IRA for many years. Estimates indicate that you generally need five to 10 years of tax-free compounding to compensate for the current payment of taxes.
- You don't expect to take withdrawals from your IRA. Since you aren't required to withdraw funds from a Roth IRA, even after age 70 1/2, your IRA balance can continue to grow on a tax-free basis.
- You want to leave your IRA balance to heirs. With a Roth IRA, your heirs receive the proceeds free of federal income taxes. Also, if you don't withdraw funds from the Roth IRA after age 70 1/2, you could potentially leave your heirs with a much larger balance than from a traditional IRA.

Once the balance is converted, a qualified distribution cannot be made until after the five-tax-year holding period. Distributions before then are subject to the 10% early withdrawal penalty, unless one of the exceptions applies.

Make sure that you are prepared to take advantage of the new Roth conversion rules in 2010. Please call if you'd like to discuss Roth IRA conversions in more detail.

Rollovers

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had to be paid on the distributions, and there was no way for nonspouse beneficiaries to extend payouts beyond the plan's terms. Some plans allowed a life expectancy payout for nonspouse beneficiaries, but this option was not very common.

New Law

Starting in 2007, nonspouse beneficiaries can make a direct rollover (a trustee-to-trustee transfer) of inherited employer plan funds to an inherited IRA. The IRS recently provided guidance on how to apply this provision. Funds can be rolled over from 401(k), 403(b), and Section 457 plans. When funds are rolled over, they must go to a properly titled inherited IRA that retains the decedent's name in the title. However, a plan does not have to give nonspouse beneficiaries the ability to roll funds over to an inherited IRA. It is up to the plan.

Funds must be made via a trustee-to-trustee transfer. If the funds are issued to the beneficiary via check, it is considered a distribution, and those funds cannot be rolled over to an IRA. If a plan won't make a trustee-to-trustee transfer, a check can be made out to the inherited IRA and still meet the requirements.

Once funds are rolled over, the distribution rules that applied when the funds were in the employer's plan continue to apply, unless a special rule is followed. To escape the plan's rules, the beneficiary must take the first required distribution using the beneficiary's life expectancy by the end of the year following the decedent's death. If this is not done, the beneficiary must take distributions based on the plan's rules, which generally require the entire balance to be withdrawn in five years.

Why Aren't 401(k) Plan Balances Larger?

Originally, 401(k) plans were viewed as a supplement to defined-benefit plans. Since it was presumed that employees would have their basic retirement income needs covered by Social Security benefits and employer-provided pension benefits, they were given significant responsibility in 401(k) plan decisions, such as deciding whether to participate, how much to contribute, which investments to select, and how to take withdrawals.

However, retirement plans have changed dramatically. As of 2004, 63% of workers with a pension plan have only a 401(k) plan, 20% have only a defined-benefit plan, and 17% have both (Source: Center for Retirement Research, March 2006). In 25 years, 401(k) plans have gone from a supplement to other pension plans to the main retirement plan for most workers. Yet, participants still make most of the choices in 401(k) plans, often making mistakes with those choices:

- **Not participating.** Approximately 21% of workers eligible to participate in a 401(k) plan do not do so. Younger workers are more likely than older workers not to participate.
- **Not making adequate contributions.** Only 11% of 401(k) participants contribute the legal maximum to their 401(k) plans. However, those with higher incomes are more likely to contribute the maximum. For instance, less than 1% of those with incomes between $40,000 and $60,000 contribute the maximum, while 58% of those with incomes in excess of $100,000 contribute the maximum.
- **Not diversifying investments.** In 2004, 32% of participants had no equity in their 401(k) plans, while 21% had 80% or more in equities. Approximately 47% had a diversified portfolio.
- **Overinvesting in company stock.** Approximately 15% of 401(k) plan assets were invested in company stock in 2004. However, most 401(k) plans do not offer company stock as an investment option. Plans with 5,000 or more participants typically offer this option, with 34% of total assets in those plans invested in company stock.
- **Not letting balances grow.** Approximately 45% of participants changing jobs cashed out their 401(k) balance rather than rolling it over into an IRA or another employer's 401(k) plan. Most of the participants who cashed out were younger employees with relatively small account balances, who did not realize that allowing these sums to grow could result in a significantly larger balance at retirement age.

These mistakes significantly affect the amount that workers accumulate in their 401(k) plans. For instance, a typical worker who reaches retirement age with $58,000 of annual wages and has contributed 6% to the 401(k) plan with a 3% employer match should have an accumulated balance of $380,000. However, in 2004, the median balance for workers between the ages of 55 and 64 was only $60,000 (Source: Center for Retirement Research, March 2006).

Please call if you'd like to discuss ways to maximize the value of your 401(k) plan.

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Business Data

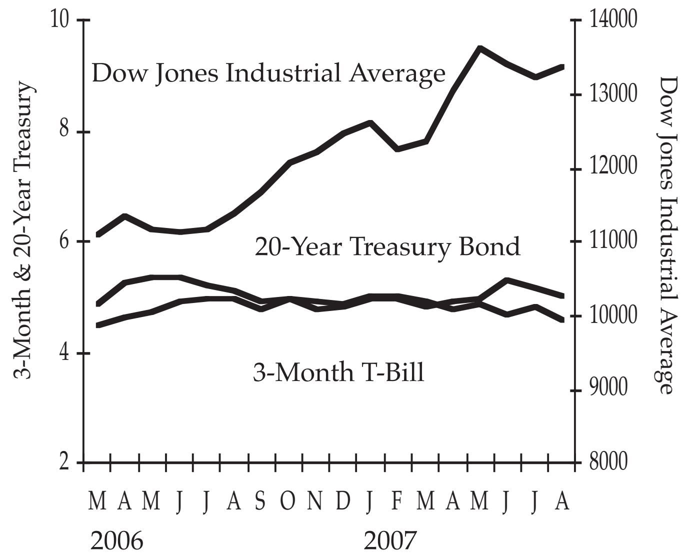
Indicator	Jun-07	Jul-07	Aug-07	Dec-06	Aug-06
	Month-end				
Prime rate	8.25	8.25	8.25	8.25	8.25
3-month T-bill yield	4.69	4.83	4.60	4.88	4.96
10-year T-note yield	5.14	5.03	4.62	4.60	4.90
20-year T-bond yield	5.33	5.19	5.00	4.82	5.11
Dow Jones Corp.	6.02	5.87	5.84	5.71	5.89
GDP (adj. annual rate)#	+2.50	+0.60	+4.00	+2.60	+2.60

	Month-end			% Change	
Indicator	Jun-07	Jul-07	Aug-07	YTD	12 Mon
Dow Jones Industrials	13408.62	13211.99	13357.74	7.2%	17.4%
Standard & Poor's 500	1503.35	1455.27	1473.99	3.9%	13.1%
Nasdaq Composite	2603.23	2546.27	2596.36	7.5%	18.9%
Gold	650.50	665.50	672.00	6.3%	7.8%
Unemployment rate@	4.50	4.50	4.60	2.2%	-2.1%
Consumer price index@	207.90	208.40	208.30	3.4%	2.2%
Index of leading ind.@	137.90	137.50	138.10	0.4%	0.4%

— 4th, 1st, 2nd quarter @ — May, Jun, Jul
Sources: *Barron's, Wall Street Journal*

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

March 2006 to August 2007



News and Announcements

Taking Required Minimum Distributions

In the year you turn age 70 1/2, you must start taking required minimum distributions (RMDs) from company retirement plans if you are retired and from your traditional individual retirement accounts (IRAs). Company owners with a 5% or more interest in the company must take RMDs from company retirement plans even if they are still working. If you don't take the RMD, you will be assessed a 50% penalty on amounts that should have been withdrawn. You are not required to take distributions from a Roth IRA after age 70 1/2.

Your RMD is calculated by taking the account balance as of the preceding year divided by the life expectancy factor from a uniform table. The table is based on joint life expectancies and assumes your beneficiary is 10 years younger than you. If your spouse is your sole beneficiary and is more than 10 years younger, you can use either the uniform table or a table based on your actual joint life expectancies. You can always withdraw more than your RMD.

The first distribution can be taken anytime before April 1 of the year following the year you turn age 70 1/2. However, if you postpone the distribution until the following year, you will have to take both your first and second distributions in the same year. Evaluate your tax situation before doing that. Two distributions may increase your income to a level where you are in a higher tax bracket, lose tax deductions or credits, or make Social Security benefits taxable. In those situations, you may be better off taking your first RMD in the year you turn age 70 1/2.

Please call if you'd like to review your situation before making this decision. FR2007-0322-0111

Rick