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Roth IRA Conversions in 2010: Goodbye, Income Limits!

Regardless of your filing status or how much you earn, you'll be able to convert a traditional IRA to a Roth IRA starting in 2010.

With the lure of tax-free distributions, Roth IRAs have become popular retirement savings vehicles since their introduction in 1998. But if you're a high-income taxpayer, chances are you haven't been able to participate in the Roth revolution. Well, that's about to change.

What is - and isn't - changing

In 2006, the Tax Increase Prevention and Reconciliation Act (TIPRA) became law. TIPRA repeals the \$100,000 income limit for conversions, and allows conversions by taxpayers who are married filing separately, beginning in 2010. This means that regardless of your filing status or how much you earn, you'll be able to convert a traditional IRA to a Roth IRA starting in 2010.

Unfortunately, TIPRA does not repeal the income limits for annual Roth contributions. However, depending on your circumstances, beginning in 2010 you may be able to make your annual IRA contribution to a traditional IRA, and then convert that IRA to a Roth. Your financial professional can help you determine if this works for you.

What are the current rules?

For 2009, if your modified adjusted gross income (MAGI) is greater than \$100,000, you can't convert a traditional IRA to a Roth IRA. This \$100,000 limit applies whether you're single or married filing jointly. And if you file your taxes as married filing separately, you can't make a conversion at all - regardless of your income level.

In addition, your ability to make annual contributions to a Roth IRA depends on your MAGI:

If your federal filing status is:	Your Roth IRA contribution is reduced for 2009 if your MAGI is:	You can't contribute to a Roth IRA in 2009 if your MAGI is:
Single or head of household	\$105,000 but less than \$120,000	\$120,000 or more
Married filing jointly or qualifying widow(er)	\$166,000 but less than \$176,000	\$176,000
Married filing separately	More than \$0 but less than \$10,000	\$10,000 or more

Convert now, pay later

Normally, when you convert a traditional IRA to a Roth IRA, you're required to include the amount converted--minus any nondeductible contributions you've made--in your gross income in the year you make the conversion.

However, to ease the pain of a tax hit in 2010, TIPRA includes a special rule for 2010 conversions only: if you convert your traditional IRA to a Roth IRA in 2010, you can report half the income from the conversion in 2011, and the other half in 2012.

For example, assume that in 2010 your sole traditional IRA is worth \$200,000, and you've made \$50,000 of nondeductible contributions. If you convert the entire IRA to a Roth in 2010, \$150,000 will be subject to federal income taxes. If you use the special rule, you can report half of the taxable amount (\$75,000) as income in 2011, and the other half as income in 2012. Alternatively, you can report the entire \$150,000 as income in 2010. (Note: state tax rules may differ.)

About New Wealth Advisors.

New Wealth Advisors is an independent, fee-only, SEC-registered investment advisor, operating as a multi-family investment office. We work with newly wealthy individuals and families to protect, grow and manage assets.

(Note that a SEP IRA can also be converted to a Roth IRA, and a SIMPLE IRA can be converted two years after you begin participating in your employer's SIMPLE IRA plan.)

Is a Roth conversion right for you?

The answer is complicated, and depends on many factors, including your income tax rate, the length of time you can invest the funds without withdrawals, your state's tax laws, and how you'll pay the income taxes due on the conversion. The advisors at New Wealth can help you determine if a conversion is right for you.

Even if you decide to convert, whether it makes sense to use the special 2010 deferral rule depends on your individual situation. It may also depend on where you think income tax rates are headed. If you expect rates to be lower in 2010 than in 2011 and/or 2012, deferring the tax hit may not be a good idea. Your financial professional can help you run projections to determine if the special rule is appropriate in your particular case.

Is "Buy and Hold" Dead?

Financial experts have traditionally held that equities belong in a portfolio because, despite involving greater risk than cash or bonds, when held over the long term they offer higher return potential. However, that conventional wisdom has come under fire since the double whammy of the dot-com crash and the credit crunch. If you're wondering whether it's time to revisit the amount you've allocated to stocks, understanding both sides of the argument can help you make a more informed decision.

A challenge to the case for equities

Much of the discussion in financial circles has centered on two factors. Until last year, the S&P 500 hadn't experienced negative returns over a 10-year period since 1939. However, in 2008 the annualized return on the S&P 500 for the previous 10 years turned negative; as of last December, the S&P's compound annual return for 1999-2008 was -1.38% - less than the 3.22% of U.S. Treasury bills.

Also, a widely discussed article by financial analyst Rob Arnott (Journal of Indexes, May/ June 2009) argued that rolling over 20-year Treasury bonds and reinvesting the income would have outperformed the S&P 500 for an even longer period, from 1969 to 2009.

Questioning the questions

Though it's true that stocks have experienced a lot of volatility in the last decade while bonds had an exceptionally good run during the period examined in Arnott's research, it's never been more important to remember that past performance is no guarantee of future results.

Opponents of Arnott's arguments contend that the conditions that produced the cited outperformance by bonds can't be counted on to happen again. Interest rates have declined substantially since the early 1980s, which helped push up bond prices. Not only are Treasury yields relatively low - bond yields move in the opposite direction from prices - but the Federal Reserve is working overtime to try to keep them that way. That means the conditions that created a favorable environment for bonds may not continue in the future. If and when interest rates and inflation start heading up, they are likely to affect bond prices.

It's also instructive to look at the period just after 1939, the last time the

S&P 500's 10-year return was negative. In 1940, the compound annual return for the previous 10 years was 1.8%. A year later it went to 6.43%, and by 1942, it was 9.35% - not far below the overall historical annual average of 9.62% since 1926.

Finally, even though the large-cap S&P 500's 10-year return was negative as of December 2008, the 10-year average for small caps was 6.44% over the same period.

The smart way to buy and hold

Even if you shouldn't expect stocks always to outperform bonds - and there's no guarantee either way - that simply underscores the value of investing in multiple asset classes. Diversification can't guarantee a profit or insure against a potential loss; not one of the 16 asset classes Arnott discusses had a positive return in September/October 2008. However, the very idea that you can't be sure which type of investment may outperform others should demonstrate diversification's value. What if the asset class you expect to provide higher returns isn't the best performer *during your time frame*?

Investing is rarely black and white. You might decide to have a core holding and be more tactical with a portion of your portfolio. And even if you are firmly in the buy-and-hold camp, that shouldn't be the same as "buy and forget about." Monitor your investments to ensure that they're still appropriate to meet your goals. The advisors at New Wealth can assist with creating a financial plan and implementing an investment plan that meets your family's specific goals and objectives.



Market data source: Ibbotson SBBI

Understanding Principal-Protected Notes and CDs

Let's say you're beginning to think stocks are looking attractive again, but you're still wincing from the beating that equities took last year. What if someone told you that you might be able to earn returns similar to those of a stock index with an investment that protects your initial investment, regardless of what happens with the market?

The good news: investments that offer protection of principal and the potential for higher returns do exist. However, they require careful consideration before you invest to make sure you understand exactly what you're investing in, what the limitations of a specific investment are, and what could potentially go wrong.

Principal-protected notes and CDs

Principal-protected notes (PPNs) are debt instruments that are typically created by an investment bank. They are one example of a type of investment known as structured products. As the name implies, a PPN is designed to return the initial investment, plus a return based on some other asset, index, or market data.

To do that, PPNs generally combine various types of investments. For example, a PPN might pair a zero-coupon bond to cover the principal with a derivative based on stock futures that determines your rate of return - if any - on that principal.





Principal-protected certificates of deposit (CDs) function much like PPNs, except that repayment of principal may be funded by a security that's covered by the same Federal Deposit Insurance Corporation (FDIC) insurance that governs other CDs.

In addition to the protection of principal, what makes PPNs so attractive to investors is that they frequently offer a coupon rate that's substantially higher than prevailing market rates. However, don't let that enticing figure be your sole consideration when evaluating a PPN.

For example, the creditworthiness of the issuer is key. A principal-protected note is essentially an unsecured debt owed by the investment bank that issued it (which may not be the financial institution from which you purchase it). If the issuer goes under, investors are treated just as other unsecured creditors are, as holders of Lehman Brothers PPNs learned to their sorrow when that company filed for bankruptcy.

Test-driving a hybrid: questions to ask

What is the investment's term? Because there's no guarantee a principal-protected note or CD will be marketable if you try to sell it before its maturity date, it's best to invest in one that matches a predictable time horizon.

What underlying assets does it involve (i.e., options, futures, or other derivatives) and what risks do they involve? The derivative component of a principal-protected note or CD may be linked to interest rates, stock

or bond indexes, an individual commodity or commodity index, or a currency or basket of currencies. Those investments and derivatives themselves involve risks that are quite different from those of a typical fixed-income security, and therefore may not be appropriate for all investors.

What interest rate does it pay? In general, the higher the interest rate, the more likely it is to be associated with volatile underlying assets, and the greater the uncertainty about your return - and indeed, whether your investment will earn anything at all.

Who issued it, and what underlies any guarantee of return or the safety of the principal? As mentioned previously, a PPN's guarantee is subject to the claims-paying ability of the issuer. If that institution is unable to repay its debt, the guarantee may be worthless.

Is there a limit on the return that a note offers? If your return is based on an index, find out if that return will be capped at a certain maximum if the index moves beyond a given level.

How is the derivative-based return calculated? For example, the return might be based on either the value of an index at maturity or on an average of prices over the term of the note.

Can the promised results be duplicated cost-effectively in a different way? Costs can be difficult to compare. Weigh them against the convenience of investing in a single note or CD rather than in separate bonds and/or derivatives.

Maturity matters

A guarantee that you will get your principal back in full applies only when a principal-protected note or CD matures. If you try to sell it before then, you could still suffer a loss. Also, don't assume a note or CD will make periodic payments of income; many pay all returns at maturity.

Additional factors to consider

- Your liquid net worth
- Your tax status
- Your risk profile
- Your age
- Your investment experience
- How the note or CD would fit into your existing portfolio



Photo by John Nelson Ferrara



Can I change investments in my 529 plan account?

The short answer is yes. During the stock market declines of 2008-2009, many 529 plan participants made investment changes in their accounts. But the rules for doing so depend on whether the change is for *future* contributions or *existing* contributions.

Future contributions. Typically, most 529 plans allow you to change your investment allocations for your future contributions at any time. Some plans let you do this online in a matter of minutes, while other plans require you to mail in a form with your new investment preferences. (Note that this seemingly inconsequential difference may be an important one if you want to act quickly.)

Existing contributions. The rules are more restrictive when it comes to changing investment allocations for your existing contributions. Generally, under federal law, 529 plans are permitted (but not required) to allow you to change the investment allocations for your existing contributions once per calendar year. But for 2009 only, 529 plans may allow you to do so twice per year. (No word yet on whether the IRS will extend this "twice-per-year" rule to 2010 and beyond, though the 529 industry is sure to lobby for it.)

If you've already made two investment changes this year but want to make another, There is a workaround: most 529 plans allow you to change your investment allocations for your existing contributions whenever you change the beneficiary of the account.

But if you don't want to change the beneficiary of your account and you're still unhappy with your investment allocations, you have one more option: you can jump ship to a different 529 plan. Under federal law, you can roll over your existing 529 plan account to a new 529 plan (college savings plan or prepaid tuition plan) once every 12 months without any federal tax penalty and without having to change the beneficiary.

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I am a conservative investor. Is a 529 plan a good way to save for college?

It can be. The investment options for 529 college savings plans have broadened dramatically since their inception in 1996. And with the market turmoil of the past year, many states have expanded the conservative investment options in their 529 college savings plans as more families look to protect their college savings from financial risk.

For example, Colorado is offering a stable value fund in its 529 plan paying 3.35% interest through the end of 2009, and a few other states are offering principal-plus-interest options that guarantee a minimum rate of interest while protecting your principal. And as 529 account holders funnel more money into conservative investment options, the list of states offering such options in their 529 college savings plans is likely to grow.

You might be asking why you should bother with a 529 plan when you could earn a comparable rate of interest on your own. Well, even if you could earn a similar rate outside of a 529 plan, you would generally have to pay income taxes on the earned interest at ordinary income tax rates. By contrast, any interest and capital gains earned in a 529 plan account are completely free of federal (and typically state) income tax, provided the withdrawal is used for the beneficiary's qualified education expenses. However, any withdrawal not used for such expenses is subject to income tax and a penalty.

Note: *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.*

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