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"Congratulations Amerika! Your health care is now completely in the hands of the same folks who couldn't protect investors from Bernie Madoff, couldn't detect a suicide bomber from Nigeria traveling through Yemen on a \$2500 ticket purchased with all cash, exacerbated history's greatest bubble by incentivizing lenders to make loans to people who never stood a chance of repaying the debt, and who write tax law. They have failed at their most basic task of protecting property, enforcing contractual rights and protecting us from fraud. And we expect them to do a better job mandating, regulating and controlling health care?" —Doug Thorburn

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WEALTH CREATION STRATEGIES

The Wealth of Individuals Part 7: Understanding and Using the Roth Conversion to Create Wealth

When Roth IRAs were introduced in 1998 I wrote they were perhaps the greatest gift ever offered to taxpayers by a Congress not known for its munificence toward those who produce wealth by saving and investing. The Roth conversion, in which funds can be moved from traditional IRAs to Roth IRAs, is a way of magnifying the wealth-creating attributes of Roths. This issue of *Wealth Creation Strategies* is largely devoted to explaining and debunking the myths surrounding Roth conversions. Because (for the majority of taxpayers) it may be the most effective tax tool for creating wealth, it is Part 7 of our Wealth of Individuals series.

The Incredible Tax Shelter Value of Roth IRA Contributions (and Roth Conversions too!)

I'm often asked, "If I put \$5,000 into my Roth IRA will it save me any tax?"

What most people are *really* asking is, "will it save me any tax *this year*?" Unless you qualify for the low-income saver's retirement credit, the answer is no. But this is short-term thinking.

Because of their permanent tax-free status and despite the fact that contributions aren't deductible, investing in Roth IRAs (Individual Retirement Accounts) can potentially save more in taxes than any other retirement plan. This fact became crystal clear to one client who didn't understand why she and her husband owed several thousand dollars in additional tax. Aside from an increase in their wage and self-employment income without a corresponding increase in withholding

and estimated tax payments, they earned about \$3,000 of interest on an \$80,000 Certificate of Deposit, which generated \$1,000 of tax. As I explained this, it dawned on me they might not have taken seriously my suggestion to invest in Roths for the past, oh, dozen years. I'd assumed they had been doing so, but since it didn't save current taxes (they didn't qualify for the low-income saver's retirement credit) I didn't have any reason to play Enforcer. And it never dawned on me she wasn't making those investments, since she always said "ok" when I suggested doing Roths and the instructions were clearly written on the cover letter sent with their tax return each year.

So I asked. She hesitantly whispered "no." I asked why not? She responded, "I was always afraid we might

need the money?" with her voice trailing off as I could hear her question her own thinking. After mentioning the obvious—she hadn't used any of it over the last 12 years—I reminded her she could take the principal contributions out at any time without tax or penalty. I reiterated that only the earnings must "stay" until the Roth account owner is 59½ (assuming the first Roth contribution was made at least five years before). Therefore, I explained, a Roth IRA is just like any other savings or investment account—except that if you follow the rules and let the earnings stay, those earnings are forever tax-free. Her "no" turned to a drawn-out "ohhhhh."

The light bulb goes on

Then I explained what she'd missed in

concrete terms by asking, “How much of that \$80,000 do you think would be inside your Roth IRAs if both of you had been making Roth contributions from their inception 12 years ago?” She nervously asked, “A lot of it?” After a quick calculation I responded, “All of it.” Then I asked, “Do you know how much tax you would have to pay on that interest income if the entire principal balance on which it was earned was in a Roth?” She squeamishly asked (by now you could hear the pain in her voice), “None?” I said “Bingo!” Then I asked, “How much tax would you have paid on the earnings if it had all been in Roth IRAs last year, and the year before that and the year before that,

etc.?” She responded, “Wow, we’ve missed a great tax shelter, haven’t we.” For icing on the cake I mentioned the fact that the earnings would also be tax-free next year and the year after that, etc. She said, “Oh crap.”

Interest rates are low and you may agree that stocks are not a good value at current prices. But anyone who can siphon funds now into a Roth IRA will have that much more to invest when values are better, even if that time is a few years off. While any one-year tax savings may not seem like much given current returns on investment, the savings over many years might amount to a small fortune.

By the way, I still generally prefer

traditional IRAs for those who qualify *and* are in higher tax brackets (which, due to the low income saver’s retirement credit and the earned income tax credit *can* include low income individuals). Everyone else with any money in a bank should probably invest in Roth IRAs. The skeptical may benefit by re-reading the now classic “I Can’t Contribute to My Roth IRA Because...”

on pp. 4-5 of the May-June 2006 *Wealth Creation Strategies* (www.doughthorburn.com/cmsAdmin/uploads/25-ThorburnMayJune06.pdf) in which I respond to numerous objections to and concerns over Roth IRAs.

What you Should Know about Roth Conversions

I have long *generally* advised clients in higher tax brackets (usually 25% federal or higher) to invest in *deductible* retirement accounts. Usually only after maxing out contributions at higher brackets have I suggested non-deductible Roth IRAs for those who are eligible. Those in *lower* brackets (15% federal and under) *generally* are best advised to invest in Roth IRAs and *not* in deductible plans (with employer-matched 401k contributions excepted and, of course, where the low-income saver’s retirement credit can be utilized).

Recently, a question crystallized: if those in lower brackets should almost never invest in deductible retirement plans, shouldn’t the reverse be true? Shouldn’t many lower-bracket taxpayers, assuming they have the funds with which to pay the tax, *withdraw* from IRAs—or, immeasurably better—convert pre-existing IRAs into Roth IRAs? As I see increasing numbers of retirees paying tax at exorbitantly high rates due to the phase-in of Social Security income subjecting them to phantom 22%, 27% and 46% “real” tax rates, I’ve become convinced this is a long-term strategy many would do well to consider. Even if you don’t think this applies to you now, the odds are at some point it will—to you or to a close family member with whom you might want to share this—and when it does,

it could pay big-time.

Most IRA owners have never considered doing a conversion because they misunderstand the idea. Since conversions and Roth IRAs in general can be incredibly helpful in decreasing taxes over the long-term, this issue is largely devoted to the subject. (Those who were expecting an issue devoted to Obama anti-care and what I believe was the most breathtaking public act of arrogance ever will have to wait. Sorry.) Let’s cover the basics of Roth conversions.

1. Tax—but never penalty—is paid on the conversion at your marginal rate for the year of the conversion (unless you convert in 2010, for which a one-time election to spread the income over subsequent years is available, discussed below in item 9).
2. You can convert any part or all of an IRA and certain other types of retirement plans to a Roth IRA at any time during the year. ONCE DECEMBER 31 IS PASSED, YOU’VE MISSED THE OPPORTUNITY TO DO THE CONVERSION FOR THAT YEAR. YOU CANNOT “GO BACK” AND DO A CONVERSION FOR A PRECEDING YEAR. (This should not be confused with making prior-year contributions, which can be made from non-IRA

funds if you are otherwise eligible—meaning you have either wages or self-employment income and your total income is low enough.)

3. Next year you can CHANGE YOUR MIND about THIS year’s Roth conversion. In what’s referred to as a “recharacterization,” you simply return *any part* you don’t want to pay tax on (plus or minus gains or losses) to the IRA by the extended due date of the tax return. “Extended due date” means October 15 if an extension was filed. “Any part” you don’t want to pay tax on means you can fine-tune the amount of the conversion after the tax return is otherwise completed. You can elect to pay tax only on the part of the conversion subject to the 15% and lower rates and none at the higher rates, or some variation. At least one client decided to pay tax at the 25% rate because she’s 80 and has a half million left in her IRA. Another opted to recharacterize the entire conversion. It’s up to you and you don’t have to decide until we finalize your return. IT DOESN’T GET ANY MORE FLEXIBLE THAN THIS!
4. Only you or a spouse who inherits your IRA can elect to convert the IRA to a Roth IRA. Any funds not

- already in a Roth cannot be converted after both you and your spouse die. This can be a good reason to convert even for those subject to higher tax rates. It's an even more compelling reason to convert for those in the lower tier brackets. Ask yourself: are my heirs in a tax bracket equal to or higher than mine? If the answer is yes, ask yourself would they rather inherit a pre-tax IRA on which they will eventually have to pay the tax, or a Roth IRA that will be permanently tax-free? Is this a great gift idea to those you love or what?! Even better: your heirs can take withdrawals over their life-spans, which means the bulk of the assets in the Roth will (hopefully) grow tax-free for decades.
5. As is true for normal Roth contributions, you can withdraw the already-taxed amount (your "basis") from a converted Roth at any time. If you're under 59½, unless you wait five years, you'll have to pay the penalty you avoided when you did the conversion (each conversion if you did more than one). If you're over 59½, there's no penalty on the previously-taxed amount. In addition, there's no penalty on the earnings, so long as you've had a Roth for at least five years. Essentially, you can view a Roth conversion as you would any other bank account: you can withdraw your "basis" at any time, subject to the rules for those under 59½.
 6. So long as you follow the above rule, funds inside the Roth grow tax-free *forever*.
 7. Roth conversions permanently reduce your traditional IRA balance, which reduces the Required Minimum Distributions (RMDs) you must take from your traditional IRA at age 70½.
 8. You never have to withdraw from your Roth IRA. Only heirs must take withdrawals (as mentioned in 4 above). The long-term wealth creation aspect to this is profound (and something you might extrapolate from "The Power of Com-
 9. pound Growth in an Inherited IRA" on pages 3-4 in the January-April 2006 edition of *Wealth Creation Strategies* (www.dougthorburn.com/cmsAdmin/uploads/24-ThorburnJanApr06.pdf).
 9. While you can spread the income from a 2010 conversion over 2011 and 2012 (obviously paying the tax in those future years rather than 2010), WE BELIEVE THIS OPTION IS OVERHYPED AND INAPPROPRIATE FOR MOST PEOPLE. First, we don't know with any degree of certainty what your income or tax rate will be in either of those two years. Heck, we don't even know what tax rates will be! Second, you can do a series of Roth conversions and spread the income without using this silly and misleading "option." For nearly everyone we suggest keeping it simple: do your 2010 conversion and "change your mind" to the extent it's too much; repeat for 2011 and 2012, etc. (But, except for estimated taxes, this hardly matters right now. You do the conversion in 2010 and we have until the extended due date of the 2010 return to decide whether to add the income now or spread it over subsequent years.)
 10. *Never* have any tax withheld on a conversion. Although there may be people for whom paying the tax out of converted funds *can* make sense (those whose tax rate is temporarily low having no other funds with which to pay the tax), the tax should *generally* be paid with separate funds, whether via current estimated taxes or, to the extent underestimated tax penalties can be avoided, with the tax return.
 11. Because you can "change your mind" after the year is over, *always* convert more than we think is ideal. I have often found, to my chagrin, money was left on the table at lower brackets when we tried to convert "just the right amount." All the planning in the world frequently doesn't pan out. Since we
 - can "change your mind" on any part or all of a conversion, it pays to over-do and then "change your mind" on any amount taxed at higher-than-we-want-to-pay tax brackets.
 12. Due to the likelihood of "changing your mind" on at least some of the conversion, the converted funds should be kept liquid at least until we decide how much to leave in the Roth. In other words, don't tie it all up in a five-year CD or annuity (which is often best avoided inside IRAs anyway).
 13. When we "change your mind," as mentioned in item 3 above we must add or subtract investment gains or losses. This can become mind-bogglingly complex if a new Roth conversion is mixed with old Roth funds. Therefore, it's usually best to set up a new Roth to receive each new conversion. You may be able to trust a full-service broker or banker for this calculation, but if you use a discount broker they'll make you do your own (which means you may have to have us do it). If you do repeated conversions, once you recharacterize you can roll whatever is left in the new Roth into any old Roth IRAs you have, leaving your "empty" Roth to receive the next conversion.
 14. You **MUST** wait 31 days after recharacterizing before doing another conversion.
 15. Those over 70½ *must* take their yearly RMDs; this amount *cannot* be converted. Only amounts in excess of the RMD can be converted.
- Health, longevity, current and future expected tax brackets, the possibility of moving to lower-tax environs, the expected disposition on death and the tax needs of heirs should all be taken into account in determining the optimal Roth conversion strategy. This is an opportunity to consult us for some serious family tax and financial planning.

Myths and Realities of Roth Conversions

I doubt there has ever been a tax strategy about which so many people have been misled and misinformed, and which has cost as many missed opportunities as Roth conversions. Let's try to dispel the myths and half-truths. Some of what follows was mentioned in the preceding article, but bears repeating.

⇒“Anyone can convert now.” The implication in many financial services ads is conversions must invariably be a good idea. No, it's not a good idea for just anyone. It *may* be for those in low tax brackets but is *generally* not for those in higher brackets, except for a few who are engaging in some serious estate planning and those whose “basis” in the IRA is relatively high compared with the total value in all of one's IRAs and SEPPs (usually, those who engaged in the “high-income earner traditional-to-Roth conversion strategy” described in the winter 2006-2007 issue of *Wealth Creation Strategies* at www.doughthorburn.com/cmsAdmin/uploads/27-ThorburnWinter06-07.pdf). More on this below.

⇒“You have one year to convert your IRAs to Roth IRAs if you qualify.” So claimed an ad touting another firm's financial acumen, along with their services. This is incredibly misleading. Previously, only taxpayers with incomes under \$100,000 could convert their IRAs into Roth IRAs. Beginning in 2010, anyone can convert. The only rule that applies exclusively to 2010 is that anyone converting may report the half of the extra income from the conversion in 2011 and half in 2012. Which leads us to the next half-truth:

⇒If you convert in 2010 you can spread the income over two years, 2011 and 2012. Oh joy. You have no idea what your income will be in those years and taxes may well be heading up. Why not do what “works” (i.e., use up the low brackets) in 2010, include it in 2010's income, and then do the same thing in subsequent years? Hello?

⇒“You have to convert your entire IRA.” No you don't. You can convert any part of it you wish.

⇒“The conversion may push you into a

higher tax bracket.” To the extent the conversion subjects you to higher tax rates, you “change your mind” and recharacterize part of the conversion. You can do just enough conversion to avoid that higher bracket if you want, so this is an idiotic objection (even though I found it in a professional tax journal whose authors should have known better).

⇒“Once you convert, you're stuck.” No you're not. You can “change your mind” on any conversion done one year any time up to the extended time to file your return the following year. This makes the area of tax law dealing with Roth conversions the most flexible known to man in terms of allowing you to decide how much tax you want to pay, at what tax brackets to pay it and when.

⇒“You should never voluntarily accelerate income, so Roth conversions don't make sense.” Oh, so you'd rather pay \$30,000 on \$100,000 in withdrawals later rather than \$15,000 over the next several years via a series of Roth conversions? Think again: because your account balances (hopefully) grow over time, even if we include the time value of money you're *always* better off paying the tax now at a lower rate than later at a higher rate if by doing so you are converting into something that earns income on which you will *never* pay tax.

⇒“Most people fall into a lower tax bracket when they retire.” I'm finding, contrary to this assertion made in *The Wall Street Journal*, they often do not. One reason is due to the phase-in of Social Security income and those nasty phantom unadvertised 27% and 46% tax rates, explained in “What's my Tax Bracket: A Focus on Social Security recipients” on pages 3-6 of the summer 2007 edition of *Wealth Creation Strategies* (www.doughthorburn.com/cmsAdmin/uploads/29-ThorburnSummer07.pdf). Another is that in many if not most instances survivors will be subject to higher tax rates, which is a great reason to

convert while both are alive (the 15% bracket, which currently goes up to \$67,900 for married filers, is cut in half—\$33,950—for single filers). This is discussed, along with other aspects of Roth conversions and marginal tax rates, on pages 2-4 of the winter 2009 edition of *WCS* (www.doughthorburn.com/cmsAdmin/uploads/35-ThorburnWinter08-09.pdf).

⇒“The older the person is, the less sense it makes to convert to a Roth IRA because there is less time to make up for the taxes paid on the conversion.” First, if you pay now at lower tax rates than later, you've already made up for the taxes paid on the conversion. Second, if your heirs are in tax brackets equal to or higher than yours, you are more than making up for the taxes you pay now due to the lower or equal rate you pay and the fact that you can convert but your heirs cannot. And because your heirs can't convert your IRA, the older you are the *more* sense it can make to convert. The professional tax journal with the objection “the older the client is, the less sense it makes to convert” also came up with this brain-child, which shows how deeply embedded the mythology is surrounding conversions.

⇒“What will my surviving spouse live on if we convert too much of the IRAs?” Survivors can supplement their income by taking withdrawals from the already-taxed Roth IRAs. In fact, those with both regular and Roth IRAs are, once the yearly RMD is withdrawn, in the unique position to decide how much tax they will pay each year by juggling income from the two types of accounts, again adding to the extraordinary flexibility of Roth IRAs.

⇒“The deep decline in values last year (and in future years) presents an opportunity to convert the lower-value traditional IRA to a Roth IRA.” This confuses the key issue, which is the marginal tax rate(s) at which you are willing to pay tax on a conversion.

Missed Opportunities, Especially with IRAs, Roth IRAs and Roth Conversions

I often remind clients we're here year 'round. A telephone call, fax or email can go a long way in preventing a mistake that could cost thousands in unnecessary taxes because of missed opportunities.

There were a number of such opportunities this year that stand out, mostly centered on withdrawing from

an IRA or failing to do so when the tax rate on a withdrawal or Roth conversion would have been insignificant. Let's look at a few examples.

One client, who is debt-phobic, took a \$10,000 withdrawal from an IRA near the beginning of the year for home repairs, thinking his income would be low for the year and his high-

est federal and state tax rate would run his usual 21%. Of course, things change when least expected. It ended up being an unusually high-income year and his tax rate on the ten grand was nearly 40%, consisting of 25% federal, 9.6% state and a phase-out of a child tax credit worth 5%.

In which year would *you* take a withdrawal if you need the money in early 2009?

	2009	2010
Withdrawal	\$10,000	\$10,000
Tax rate	40%	21%
Interest on short term loan		\$400
Tax and interest	\$4,000	\$2,500
A phone call would have been worth		\$1,500

If he had called I'd have suggested a short-term home equity line of credit (variable rate, 4%) which, it turns out, he would have been able to pay within months out of the unexpected increased income. If the income remained low he could have taken a withdrawal later in the year when we could confirm he'd be in a low bracket, using the funds to repay the loan at a nominal cost. The good news is he took the withdrawal from *his* IRA—he's over 59½ while his wife is not—so he didn't get hit with penalties (their 40%

bracket would have turned into a 52.5% rout with the 10% federal and 2.5% state penalties, had *she* taken the withdrawal).

Another client retired and paid off her home in late September with a \$50,000 IRA withdrawal. I'm not one to argue over paying off debt, but she took the withdrawal on top of the \$60,000 salary she earned, which cost her almost 35% (25% federal, 9.6% state). In 2010, when her income consists only of a small pension, she could have taken at least \$20,000 at the lower

brackets (averaging 20% or so federal and state) and done the same thing in 2011 and have her home nearly paid off. The extra interest she'd pay would be *way* more than covered by the lower tax rates. We figured in retrospect she could have saved at least \$7,500 in tax at a cost of about \$2,900 in interest (her loan cost 5.5% on the unpaid balance), if only she had called us. Her income is prospectively fixed, so she could have taken withdrawals at the beginning of each year to pay down the loan.

In which year would *you* take the withdrawal if you wanted to pay off the home?

	2009	2010-2012	2010	2011	2012
Withdrawal	\$50,000	\$50,000	\$20,000	\$20,000	\$10,000
Tax rate	35%	20%	20%	20%	20%
Extra interest on the loan		\$2,900	\$700	\$1,650	\$550
Tax	\$17,500	\$10,000	\$4,000	\$4,000	\$2,000
Tax and interest	\$17,500	\$12,900	\$4,700	\$5,650	\$2,550
A phone call would have been worth		\$4,600 (2009 tax less other years' tax & interest)			

Paying tax now rather than later can save a lot of tax

The more egregious errors revolved around a failure to pay tax by accelerating income, which seems counter-intuitive. But ask yourself this question:

Would you rather pay \$1,500 in tax this year or \$4,500 next year?

Even if it's a choice between paying now and 10 years from the now the answer should be obvious, especially if it's between doing a Roth conversion this year and taking an IRA withdrawal in some future year. This is particularly applicable to those with large IRA balances whose income is temporarily low.

A few clients could have withdrawn from an IRA or converted to a Roth IRA roughly \$15,000 and paid about \$1,500 in tax, while in other years that same \$15,000 (stacked on top of their other "usual" income) would cost on the order of \$3,000 to \$4,500. You read that right: they could have paid a 10% tax last year on income that would in any other year be taxed at a 20-30% rate. Talk about "missed opportunity." They believed the media hoopla and misinformation that is so prevalent regarding Roth conversions, particularly the idea that they could convert in 2010 and spread the tax over the following two years (an idea thoroughly debunked in the preceding two articles).

Several retirees suffered unexpected drops in income and didn't think it was important enough to call. We "knew" that one of them, whose income has always been taxed at a marginal rate of 35%, would "still" be in the 35% bracket even without taking

her Required Minimum Distribution (RMD). However, other income unexpectedly dropped and it turned out she could have converted \$10,000 of her IRA to a Roth at a 24% average rate. We're not talking an enormous savings, but \$1,100 ($\$10,000 \times 11\%$) is \$1,100. With RMDs resuming in 2010 she will likely be in the 35% tax bracket for the rest of her life. Her heirs are well-to-do and will pay tax at possibly even higher rates when they inherit whatever is left in the IRA. There will likely never again be an opportunity to save tax on withdrawals (she's 80 and still has several hundred thousand dollars in her IRA). Similar errors cost other clients opportunities to pay tax at (for them) unusually low rates on \$10,000 to as much as \$50,000 of income.

One client missed an opportunity to invest in a contributory IRA that would have saved her 30% of the invested amount, when her tax bracket was always, until 2009, 15%. She began collecting Social Security and continued to work (so yes, for this and other reasons it can very helpful to let us know before you begin collecting). This combination put her into the phantom 27.75% marginal federal bracket (15% plus 15% of the 85% phase-in of Social Security income). Unfortunately, in one of those "everything that could go wrong went wrong" scenarios, for the first time ever she went on extension. By the time we realized what happened, it was too late to invest in the 2009 IRA. Please remember: we ask everyone to send us their "OLDS" (Official Looking Documents) by mid-February.

IRA planning is a great reason to do so.

Sometimes there's some serious planning surrounding a divorce, a failure to plan for which nearly cost one client dearly. Her cost basis of a rental house, which she had owned for decades and fully depreciated, was only \$10,000. She'd borrowed heavily against it over the years and owed \$110,000. She was keeping the family home and had to sell the rental to pay an \$85,000 "equalization" payment to her soon-to-be ex-husband. She called to tell me the house was in escrow for \$200,000 net of selling costs. She had been thinking, as many people do, that she'd owe tax on the difference between the \$200,000 and \$110,000 loan and asked what that tax would be. Wrong assumption: the profit on which she'd owe tax was \$190,000.

She had already borrowed \$100,000 of her profit and it was time to pay the piper. The tax was going to cost her \$44,000. I told her if there was any chance of helping the house fall out of escrow, let it. It did, and we were able to find a far cheaper way of paying the equalization payment.

I find that clients all-too-often are in one of several mindsets: "I don't want to bug Doug," "This is too small," "It's not relevant," "Doug will charge me too much for asking," etc. You won't bug me, if you thought of it it's not too small or irrelevant, and our fee will likely be *far* less than the savings. As the saying goes, an ounce of prevention is worth a pound of cure.

Bankers and Brokers Say the Darnedest Things about Roth IRAs and Roth Conversions

Many financial institutions do not properly train their staff to either understand IRAs and Roth IRAs or to know the limits of their knowledge and ask for help before giving incorrect advice. At the risk of additional repetition and insulting some bankers and brokers, examples from this Season include:

➤ A client asked her broker to convert \$6,000 of her IRA to a Roth (which coincidentally is the maximum allowable yearly contribution of new

money for someone over age 49). She was told she wasn't eligible for a Roth because she didn't work. Ok, maybe she said "contribution," but an aware broker would have said, "You must mean 'conversion.'" Another broker in the same office confirmed the erroneous advice and—big mistake—she didn't call us from the broker's office. She ended up not doing the conversion, on which she would have paid tax at a 21%

rather than her usual 35% rate.

- Another client was told she couldn't do a Roth conversion because she was too mature ("old"). No, you are never too mature for a Roth conversion.
- Still another was informed he couldn't invest in a contributory Roth because he was over 70½. While true for traditional IRAs, there is no age limit for Roth IRA contributions so long as the person works and invests no more than an amount equivalent

to earnings (subject to the \$6,000 yearly maximum).

- A banker talked a client into tying up the entire amount of a Roth conversion in a two-year CD. Since we never know for sure how much of a conversion is optimal until finalizing the return, this is not a great idea. In almost every case, we purposely over-convert, knowing we will “recharacterize” (change our mind on) some of the conversion. An early withdrawal penalty is imposed by the bank on a CD that must be broken in order to recharacterize back to a traditional IRA, even though both the traditional and Roth IRAs are at the same bank. We always suggest an amount that should be liquid the following March (the maximum amount we might want to recharacterize).
- A broker never asked a client if the traditional IRA in which she was investing through him was deductible. Because she was investing in her company’s 401k, it wasn’t—and she knew it wasn’t and therefore thought she didn’t need to tell me about it. I never dreamt to ask, nor did I ever see any paperwork that would have given me a clue. By the time I found out about the contributions to her non-deductible traditional IRA she had \$10,000 invested. When she withdraws from the IRA, she’ll pay tax on the profit, which is currently \$4,000. If she had instead been investing these funds in a Roth, for which she was eligible, *none* of the profit would *ever* be taxed so long as she follows the usual rules (age 59½, etc.). I suggested converting it to a Roth IRA now because the more it grows, the greater the tax will be later and the ratio of non-taxable basis is high relative to the total value. Remember: I need to know about all IRAs in which you invest, preferably before you do so.
- A banker scared an elderly client out of recharacterizing part of her Roth conversion. Remember the rule: convert this year and change your mind on part or all of it next year. No big deal. She’d converted \$30,000, the first \$20,000 of which cost her only \$3,000 (15% average tax rate) but the last \$10,000 of which cost her \$4,000 (40% rate). Obviously, she should have “changed her mind” on that last \$10,000, but because the banker made it seem so complicated (“and it gets reported to the IRS!”) she opted against a recharacterization. I’d like to hurt that banker.
- A broker told another elderly client that the \$20,000 conversion I suggested made no sense without a

“long-term plan.” Say again? Fortunately, the client called me and went ahead with it—paying a 20% tax on the conversion rather than her usual 35%. You don’t need a “long-term plan” to convert at 20% when we know you’ll pay 35% for the rest of your life. I’d like to hurt that broker.

- “The timing of the conversion doesn’t matter. You can do it next year.” So said a broker to a client who requested a conversion in early December and for whom the conversion was not complete as of December 30. OH YES IT DOES MATTER! When we suggest a conversion for a particular year, it’s because the situation for that year is ripe for a conversion. The conditions may not repeat in subsequent years, or the conversion may be one in a planned series of conversions. This client is in his 80s, has a half million in his IRA and wants to use up the 25% federal tax bracket up to the point at which Medicare premiums increase (\$85,000 of “adjusted” income for 2009 and 2010 for a single filer). Had the conversion not been completed by December 31 (due to our intervention, it was), there would have been an additional \$25,000 in his IRA on which his heirs will have to pay tax.

New Exorbitant Tax Rate Uncovered

There are nominal, or what I call “fraudulently advertised” tax rates and there are real tax rates. The real ones can hit hard. During the Season, one knocked a couple of clients for a loop.

Mr. Single was eligible for the American Opportunity Credit (one of the post-secondary education credits), which is worth as much as \$2,500 *per child*. It phases out at incomes between \$80,000 and \$90,000 for single filers (\$160,000 and \$180,000 for joint filers). At that income, one is normally subject to an advertised 25% marginal federal income tax rate, 9.6% California rate, 7.65% Social Security and Medicare rate and 1.1% State Disability Insurance rate, for a total marginal tax hit of over 43%. Mr. Single qualified for the maximum \$2,500 credit if his in-

come was low enough—under \$80,000—and zero if his income was too high—over \$90,000. The extra “unadvertised” rate in that \$10,000 phase-out zone, then, was (\$2,500 divided by \$10,000 =) 25%, which created a *real* marginal rate of 68%. His income was in the middle of that zone in 2009. Since he’ll qualify for the same credit in 2010, I suggested that if his income ends up being the same some unpaid time off near year-end might do him some good.

I wondered how high a tax rate he might have been subject to if he qualified for another credit—the “first” first time homebuyer’s credit, which phased out at incomes between \$75,000 and \$95,000 for single filers (\$150,000 and \$170,000 for joint filers). Since this

\$8,000 credit phased out over a \$20,000 span of income, the additional phantom unadvertised marginal tax rate was (\$8,000 divided by \$20,000 =) 40%. Our single parent with child in college qualifying for both the education and first-time homebuyer credit with income between \$80,000 and \$90,000 could be subjected to a more-than-confiscatory 108% marginal tax rate. Out of hundreds of thousands qualifying for these credits, the odds are more than one taxpayer inadvertently found his way into this absurd bracket. (BTW, if any geeks out there picked up on it, yes, the phantom rate would have been 133% if Mr. Single first-time homebuyer had two qualifying children. Note to Octomom: your tax rate could be 243% even without

the homebuyer's credit if you fall into this trap once the octuplets are of college age.)

Mr. and Mrs. Joint Filers suffered the same fate as our single client but don't need to take a vacation to solve the problem. Not having taken full advantage of 401k's in 2009, their combined income was \$170,000. With two children in college, they lost half of the potential (\$2,500 *per child* =) \$5,000 credit. Since income is expected to stay the same in 2010, by plunking an addi-

tional \$10,000 into 401k's their total income for purposes of determining the credit will drop to \$160,000. Their education credit will increase by \$2,500, their federal income tax will plummet by \$2,500 and their state income tax will decline by \$955, for a \$5,955 tax savings in exchange for a \$10,000 investment in their 401k. They agreed this is a no-brainer of an opportunity for 2010.

Oh, and to add a touch of vinegar, the \$400 per person Making Work Pay

Credit phases out for single filers with incomes between \$75,000 and \$95,000, which adds another 2% to the phantom rate (yup, that's a possible 110% total marginal rate for our single homebuyer with one child in college). Remember this the next time you want Congress to solve a problem. (You want the same people who write tax law to more completely control your health care? Surely you jest.)

Making Work Pay Credit and Kids

As you may recall, a new Making Work Pay credit shaves \$400 off the tax for single filers with total income of under \$75,000 and phases out at \$95,000. The credit is \$800 for married couples whose combined income is less than \$150,000 and phases out completely at incomes of \$190,000. There are several problem scenarios alluded to in the winter 2010 issue of *WCS* (pages 3-4, at www.doughthorburn.com/cmsAdmin/uploads/39-ThorburnWinter10.pdf), which center on the fact that while withholding tables take the credit into account, taxpayers may end up qualifying for a reduced credit or no credit at all when filing their returns. For example, if one

spouse earns anything less than \$150,000 and the other earns any amount over \$40,000, the total of which between the two is at least \$190,000, the withholding tables allow two \$800 non-existent credits. If each had two employers, the total under-withholding could be as much as (\$800 x 4 =) \$3,200.

One scenario was omitted: a dependent child earning over \$5,650 (the "standard deduction" on which no tax is levied on work-related income). While the withholding tables credit the \$400 pro-rata over the course of a year, a dependent isn't eligible for the credit. Several dependent children for whom we prepared 2009 returns each earned

in the \$10,000 range. Since the marginal tax rate is 10% on \$8,000 of income in excess of that first \$5,650, the "expected" credit built into the tables resulted in little or no federal income tax withheld. Each of these teens and young adults owed several hundred dollars. With a full year of under-withholding in 2010 (the tables were changed in April 2009) any dependent earning over \$9,650 in equal amounts over the course of a year and who claims "single" with zero allowances will likely owe \$400. To avoid this result, a dependent can ask an employer to withhold an additional amount to cover the expected tax liability.

Dick and Jane's Guide to Modern Financial Theory

Jane owned a bar. She realized that almost all of her customers were unemployed alcoholics who wanted to drink and couldn't pay. She was a smart cookie and came up with a plan: let her customers drink now and pay later.

Jane's customers drank and drank, and she ran a tab. Word got around about Jane's "drink now, pay later" plan and more alcoholics, knowing she would sell them booze on credit, flocked to her bar. She soon had more business than any other bar in town.

Jane also figured out that by extending credit for the hooch, she could raise her prices and nobody cared. Jane's gross revenue began to increase dramatically.

Dick, a hot-shot vice-president at a local bank recognized that these customer debts could be treated, in today's brave new world, as a form of collateral

and increased Jane's debt limit.

The head honchos at the bank figured out they could transform these customer loans into Drinkbonds and Pukebonds and bundle them for international security markets, where they could be traded. They sold like hotcakes.

One day, with Jane nearing her debt limit, Dick demanded payment. Having a sudden need for cash, Jane tried to collect on the drinking debts from her alcoholic patrons. Of course, as unemployed alcoholics, they couldn't pay, forcing Jane into bankruptcy. She closed the bar and her employees joined the alcoholics on the unemployment line.

The values of Drinkbonds and Pukebonds collapsed, which wiped out the bank's ability to issue new loans.

Credit and economic activity in the area froze. Jane's suppliers, who had granted her generous payment extensions and had invested their firms' pension funds in the now-worthless Drinkbonds and Pukebonds, wrote off the debts and lost much of their pensions. Her wine supplier closed the doors on a family business that had lasted three generations and her beer supplier was taken over by a Mexican competitor, who closed the local plant and outsourced 150 jobs to Mexico.

Since ours is not a free market system, but rather a crony-capitalist one, the bank and brokers were bailed out by their friends in Government. The funds for this bailout came from new taxes levied on employed, middle-class, non-drinkers who never found the time to set foot in Jane's bar.