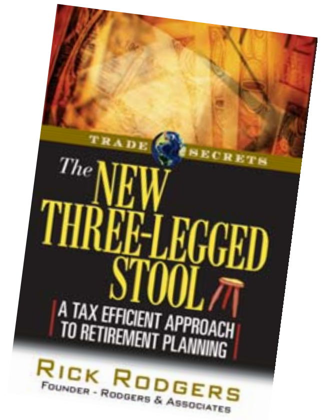
The New Three-Legged Stool ....Update



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The Ban on Roth Conversions Has Ended

Everyone is now free to convert a traditional IRA to a Roth. The $100,000 cap on adjusted gross income (AGI) has been lifted beginning in 2010. The income ceiling for Roth contributions however remains in place. Contributions begin to be phased out for joint filers when their AGI reaches $167,000 and is eliminated at $177,000. For single filers the phase out begins at $105,000 and is eliminated at $120,000. If your AGI is above these levels you can still make a contribution to a Roth by first making a non-deductible contribution to a traditional IRA and then immediately converting it to a Roth. There are no income limitations to making non-deductible IRA contributions. However, there may be tax implications to doing this if you have other IRA accounts.

Converting an IRA to a Roth generally makes sense if you expect to be in the same or a higher tax bracket in retirement. You should also be able to afford to pay the tax on the conversion from other sources so the entire amount of the conversion remains in the Roth. A significant advantage to converting this year is the ability to defer paying the tax on your conversion. Taxpayers that make Roth conversions in 2010 can elect to defer 50% of the income to 2011 and 50% to 2012. The ques-

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Will Inflation Return In 2010?

Record government borrowing, the shrinking US dollar and rising commodity prices have many people fearing a spike in inflation. The Federal Reserve has kept interest rates extremely low in an effort to stimulate the economy. If the economy remains weak and inflation returns, how will the Fed be able to combat inflation without killing any economic recovery that might be under way?

Some pundits are saying that you need to own gold to protect yourself from inflation. Yet gold has historically not been a very good inflation hedge. Gold prices have already risen dramatically mainly as a knee-jerk reaction to the financial crises last year. If you are concerned about inflation, a better hedge may very well be to own Treasury Inflation-Protected Securities (TIPS).

Those who owned bonds in 1994-1995 remember what it was like when interest rates started rising and bond prices fell. While that is not likely to happen overnight today, given the slow pace of the economic recovery and very low inflation, it is good to be prepared.

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The Ban on Roth Conversions is Over

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tion is – should you convert and if so how much of your IRA should be converted?

WHEN IN DOUBT – CONVERT! AND DO IT NOW

Many people have asked me how I can be so sure that converting to a Roth is the right thing when tax law is so uncertain. We know that the Bush tax cuts are expiring at the end of 2010 but many people believe they will be extended for some taxpayers. The uncertainty of the health care legislation and how it will be paid for could be another tax trap for upper income people. Wouldn't it be better to wait until the tax law changes have been passed?

You don't need to wait because you can always undo your Roth conversion until your filing deadline. That deadline is April 15, 2011 and could be as late as October 15, 2011 if you file for an extension. Up until the deadline you could undo all or part of your conversion and it would be like you never converted in the first place. My advice is to convert the maximum amount you can afford to pay for with funds outside of the IRA. Let the financial markets work for you from now until April 2011. Rising financial markets and favorable tax laws may signal that you want to keep everything in the Roth and pay the tax. If not, undo some of the conversion until the tax bill is where you want it to be. Next April it will be too late to make a conversion for 2010. It is always better to convert too much and then undo part of it later than to convert too little and not be able to do anything about it after the year has ended.

Start by doing a projection of what your taxable income will be in 2010 without the IRA conversion. How much income can you add to 2010 without going into the next higher tax bracket? The 2010 income tax brackets are a little higher than 2009. Tax brackets are indexed to inflation each year. Keep this in mind when you are deciding whether to defer income from the conversion to 2011 and 2012. Tax rates for the brackets are the same as 2009 but this may change in 2011. Use this chart to help plan for 2010.

MARRIEDS: If taxable income is	**The tax is**
Not more than $16,750	10% of taxable income
Over $16,750 but not more than $68,000	$1,675.00 + 15% of excess over $16,750
Over $68,000 but not more than $137,300	$9,362.50 + 25% of excess over $68,000
Over $137,300 but not more than $209,250	$26,687.50 + 28% of excess over $137,300
Over $209,250 but not more than $373,650	$46,833.50 + 33% of excess over $209,250
Over $373,650	$101,085.50 + 35% of excess over $373,650
SINGLES: If taxable income is	**The tax is**
Not more than $8,375	10% of taxable income
Over $8,375 but not more than $34,000	$837.50 + 15% of excess over $8,375
Over $34,000 but not more than $82,400	$4,681.25 + 25% of excess over $34,000
Over $82,400 but not more than $171,850	$16,781.25 + 28% of excess over $82,400
Over $171,850 but not more than $373,650	$41,827.25 + 33% of excess over $171,850
Over $373,650	$108,421.25 + 35% of excess over $373,650
HEADS OF HOUSEHOLDS: If income is	**The tax is**
Not more than $11,950	10% of taxable income
Over $11,950 but not more than $45,550	$1,195.00 + 15% of excess over $11,950
Over $45,550 but not more than $117,650	$6,235.00 + 25% of excess over $45,550
Over $117,650 but not more than $190,550	$24,260.00 + 28% of excess over $117,650
Over $190,550 but not more than $373,650	$44,672.00 + 33% of excess over $190,550
Over $373,650	$105,095.00 + 35% of excess over $373,650

SHOULD YOU PAY THE TAX IN 2010 OR DEFER IT

Fortunately you won't have to make this decision until you are ready to file in 2011. The answer to this will greatly depend on whether Congress extends the Bush tax cuts or not. The President has pledged to not increase income taxes for those earning less than $250,000. This would imply that the Bush tax cuts will be extended to everyone earning less than that amount. Anyone earning more than $250,000 will see the top tax rate increase to 39.6%. Keep in mind that the amount of the conversion needs to be included in this amount. I would advise you to plan to keep your income plus conversions under $250,000 if you think you will be deferring the income into 2011 and 2012.

Higher income taxpayers should consider the other benefits of paying the tax in 2010. You will not lose any itemized deductions and personal exemptions in 2010 because all the phase outs are finally eliminated. In 2011, itemized deductions (other than medical expenses, investment interest and casualty losses) will again need to be reduced by 3% of the amount of your AGI that exceeds $170,000. Personal exemptions are reduced by 2% of each $2,500 of AGI over $255,000 for joint filers and $170,000 for singles.

A final consideration for seniors on Medicare is the premium hikes based on AGI. Income from Roth conversions could cause your Medicare premiums to increase significantly. The premiums for those already on Medicare Part B will remain at $96.40 per month in 2010. For anyone signing up in 2010 the premium will start at $110.50 per month. Premiums are increased based on AGI according to the following schedule:

* * *

MEDICARE PART B PREMIUMS

For Marrieds: If your 2008 modified AGI is more than	but not over	Your 2010 monthly premium will be	For Singles: If your 2008 modified AGI is more than	but not over	Your 2010 monthly premium will be
$170,000	$214,000	$154.70	$85,000	$107,000	$154.70
$214,000	$320,000	$221.00	$107,000	$160,000	$221.00
$320,000	$428,000	$287.30	$160,000	$214,000	$287.30
$428,000	—	$353.60	$214,000	—	$353.60

"Start by doing a projection of what your taxable income will be in 2010 without the IRA conversion. How much income can you add to 2010 without going into the next higher tax bracket?"

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Will Inflation Return in 2010?

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Bond prices fluctuate with interest rates. Interest rates react to the outlook for inflation. If the outlook projects rising inflation, the real purchasing power of bond interest payments falls and bonds paying a fixed interest rate become less valuable. If inflation is decreasing, the opposite is true—real purchasing power goes up with bond prices.

The latter is the case today, with inflation benign and bond yields approaching record lows. The collapse of the equity markets from the highs in October 2007 has encouraged risk-adverse investors to buy bonds . . . lots of them. And they have been rewarded with rising principal value in their bond holdings as interest rates and inflation continue to fall.

But that scenario could change once our economy gets back on track. TIPS are also called "anti-bonds," because the original principal (face value) is adjusted with changes in inflation rates. The Treasury then pays interest on the adjusted face value of the bond, ensuring a gradually rising stream of interest payments (assuming inflation continues). At maturity, TIPS investors will receive the original face value plus the sum of all the inflation adjustments since the bonds were issued.

As a result, TIPS offer a true hedge against inflation. The real purchasing power of the interest payment moves higher to account for changes in inflation. A traditional bond, on the other hand, provides a "nominal return." It maintains a fixed face value until maturity, with no adjustments for inflation. For example, if you receive a 4% interest payment from a bond and inflation is 1.5%; your real return is 2.5%.

TIPS were first issued by the U.S. Treasury in 1997. However, other nations, including the United Kingdom, Canada, Sweden, Australia and New Zealand, have been issuing inflation-protected bonds for a number of years.

A good example of a TIPS investment would be when an individual sets aside retirement funds in an IRA. Purchasing $100,000 in TIPS locks in this amount in real terms. Whatever the inflation rate until the individual's eventual retirement, the $100,000 would be completely "indexed"—its value would be increased to offset any increases in inflation.

TIPS have unique tax characteristics that make them better suited to IRAs or other tax-advantaged accounts. Because you pay tax each year on the annual interest payments you receive as well as the inflation adjustment, if you held the securities in a taxable account, you would pay income tax on money you wouldn't see for years.

TIPS are not without risk. Since they are guaranteed by the federal government, they are considered to be free from credit risk; however, their price will move up and down with interest rates like other bonds.

Life is good for bond investors today, but keep in mind that the time to buy insurance is when you don't need it. This holds true for TIPS as well.

Information and examples in this article are of a general nature. The information reflects the opinion of Rick Rodgers and Rodgers & Associates on the date written and is subject to change at any time without notice. Due to various factors, including changing market, tax, and legal considerations, the content may no longer be reflective of current opinions or positions. The information provided should not be deemed to constitute financial, investment, tax or legal advice.