VESTPOINTEWEALTH
MANAGEMENT

602-212-1040 Fourth Quarter 2010

Roth IRA Conversion Isn't All Or Nothing Proposition

With all of the recent buzz about Roth IRA conversions, it's easy to get the wrong impression. While for many people establishing a Roth IRA is a great way to get tax-free retirement income, moving assets from a traditional IRA to a Roth doesn't make sense in every case. And even if the positives outweigh the negatives, it may be best to convert only a portion of your IRA assets.

The Roth IRA, created in 1997, can be a remarkable retirement planning vehicle. Qualified distributions from a Roth that has existed for at least five years are completely exempt from income tax. You're eligible to receive this income once you reach age 59½, and qualified distributions are also possible in case of death or disability or to pay up to $10,000 of first-time homebuyer expenses. And with a Roth IRA, you never have to make withdrawals during your lifetime. That contrasts with a traditional IRA, which requires mandatory distributions after age 70½. With a Roth, if you don't need the money, investment gains can continue to compound throughout your lifetime, and your heirs can enjoy the tax-free income (though they'll have to take required minimum distribution).

Before 2010, you could convert a traditional IRA to a Roth only in a year in which your modified adjusted gross income didn't exceed $100,000. Thanks to the Tax Increase Prevention and Reconciliation Act of 2005, this dollar cap has been removed, and now all retirement savers, even those with stratospheric incomes, are eligible to switch.

The primary reason not to convert is the price tag. Income tax is inescapable, and if you didn't pay tax on contributions to your traditional IRA, you'll have to pay up later—either when you move the money to a tax-free Roth IRA, or when mandatory distributions begin. In both cases, you'll be taxed at ordinary income rates, and if you convert a large account, that flood of income may push you into the highest tax bracket (if you're not already there). The only consolation is you can spread out the tax on 2010 conversions over 2011 and 2012. Tax on conversions in later years will have to be paid right away.

Deciding whether to convert your traditional IRA, and how much to move to a Roth, means analyzing many interconnected variables. One of the most important involves tax rates—how much you'll pay on a conversion versus what you would pay if you left the assets in a traditional IRA and withdrew the money during retirement. You might ordinarily expect taxes to be lower during retirement (because you'll likely earn less then), and that could reduce the value of a Roth's tax-free income. But higher tax rates may be coming, particularly for top earners. You'll also need to factor in these other variables.

- Your age and the ages of your spouse and the potential heirs of your IRAs

(Continued on page 4)

Happy New Year!

We wish all of you a Happy New Year and a healthy and prosperous 2011. While the economy still has challenges, the stock market managed to post respectable returns for 2010.

Given the "Bush tax cuts" extension that was just recently passed, we are optimistic about 2011. With interest rates low and the economy on a much better path than it was two years ago, we foresee unemployment finally starting to decrease in 2011. This should also help consumer confidence.

Interest rates have started to rise recently, though, and that is a cause for concern. This has happened even in light of the Fed's second round of bond buying. If interest rates rise dramatically, fixed-income investors will see a decrease in their values and the higher interest rates will provide competition for stocks.

While there are always things to be concerned about in the economy, we think that adhering to a well laid out investment plan is still the best formula for a successful portfolio.

Lastly, we want to take this opportunity to once again thank our clients and friends for making 2010 such a success!

Do A Direct 401(k) To Roth Rollover

In the not-so-distant past, it wasn't particularly easy to roll over funds from a 401(k) plan to a Roth IRA, which can provide tax-free income during retirement or for your heirs. Now, it's a relative snap. What's more, the IRS has provided new guidance on how to complete this maneuver.

Prior to the Pension Protection Act of 2006 (PPA), it took two steps to complete a 401(k) to Roth rollover, and it was possible only if your income didn't exceed a specified limit. First, you transferred funds from your 401(k) to a traditional IRA. Next, you converted the traditional IRA to a Roth, paying income taxes on the amount of the conversion. But you could do this only in a year in which your modified adjusted gross income (MAGI) didn't exceed $100,000.

The PPA fixed part of the problem. Beginning in 2007, you were allowed to roll over funds directly from a 401(k) plan to a Roth, bypassing the traditional IRA. But you still might have been blocked by the $100,000 limit.

That impediment no longer exists. Based on a tax law change that took effect in 2010, you may now convert to a Roth regardless of your annual MAGI. And, for conversions completed in 2010, you can split taxable conversion income between 2011 and 2012. That lets you postpone the tax hit of converting to a Roth, and you may pay less overall if the smaller taxable amount keeps you out of a higher tax bracket.

The IRS recently issued rulings clarifying aspects of a direct rollover. The guidance included these points:

- You can convert to a Roth IRA from retirement plans including 401(k)s, 403(b)s, and 457(b)s.
- A direct rollover to a Roth isn't subject to automatic 20% withholding. But you can agree to voluntary withholding.
- Beneficiaries may make rollover contributions to Roth IRAs. Also, surviving spouses who complete a rollover to a Roth IRA may treat the Roth IRA as their own.
- If funds in a designated Roth 401(k) account are rolled over to a Roth IRA, the rollover isn't taxable, whether or not the transfer is a "qualified distribution."
- Other transfers, except for amounts representing after-tax contributions to your plan, are taxable.
- If you own company stock in a 401(k), you will not be taxed on the "net unrealized appreciation" (NUA) of the stock when it's distributed. But you can't avoid tax on the NUA by rolling over assets directly to a Roth.
- If you're married, you no longer need to file a joint return to benefit from the rollover provisions.

This is just an overview. We can work with you to weigh the merits of a Roth conversion and help you follow the rules governing such transfers. ●

GRATs Survive The Legislative Axe

Reports of the death of the grantor retained annuity trust (GRAT) have been greatly exaggerated. Provisions in the Small Business and Infrastructure Jobs Tax Act of 2010, approved by House of Representatives last March, would have severely restricted the benefits of GRATs, a popular wealth transfer tool that can minimize estate and gift tax liability. But the proposed legislation stalled in the Senate, and its future remains in doubt.

A GRAT is typically set up as an irrevocable trust into which you transfer business interests or other income-producing property, such as real estate. The trust pays you, the "income beneficiary," an annual annuity during a term that may be just a few years. When the trust expires, the remaining assets are transferred to "remainder beneficiaries," who could be your children or grandchildren.

The original transfer into the trust, which removes assets from your estate, is considered a taxable gift. But its value is based on a projection of what the assets would be worth at the end of the trust term, taking into account the payments to you and assuming that the assets appreciate at a special rate the IRS updates each month to reflect current interest rates. Recent IRS rates have been quite low—just 2.6% in August 2010, compared with 6.2% three years earlier—and that creates very favorable conditions for GRATs. A low rate translates into a low projected remainder, and that minimizes your gift tax liability. It's often possible to "zero out" a GRAT, so that it is projected to be exhausted during its term by the payments to you. With the calculated remainder having no value, you pay no gift tax. But if assets appreciate at a rate that exceeds the IRS number, there will indeed be something of value to go to your beneficiaries.

The House-passed bill would

Asset Protection For Desperate Times

Even in the best of times, people with significant assets may find themselves on the wrong end of a lawsuit. Most physicians, for example, will be sued for malpractice at least once during their careers, and they pay high premiums for liability insurance, which may not cover the entire exposure. Other professionals and business owners also are frequently dragged into court, and adverse judgments may put family assets at risk.

But if the wealthy are targets of lawsuits even when the economy is strong, they're all the more vulnerable these days, when financial desperation may motivate people to take a legal shot at anyone for any reason. And if a judge or jury sides with the plaintiff, a defendant could lose business interests, investments, or other property.

In some states, the simple act of purchasing life insurance and annuities can help to protect assets. But whatever strategy you follow, you need to act before there's a problem. If you're already being pursued by creditors or embroiled in a lawsuit, the courts may disregard moves to shield your property.

Consider these possible asset-protection strategies and vehicles.

Transferring property. One simple way to protect assets is to give them away. You can transfer as much property as you like to your spouse (if a U.S. citizen) free of estate or gift tax, and under the annual gift tax exclusion, you can also make gifts of up to $13,000 a year to anyone else. Moreover, you're entitled to a lifetime, cumulative gift tax exemption of $1 million. But making property gifts means relinquishing control, and spousal transfers may create estate tax complications.

Forming a corporation. If your fortune is tied to business interests, a traditional method for avoiding personal liability is to establish a C corporation. In the absence of fraud, you normally won't be liable for corporate debts, but you also aren't necessarily protected against professional liability if you are a professional. The personal liability protection of a C corporation is not impregnable, however, as the courts have increasingly allowed persistent plaintiffs to "pierce the corporate veil" and reach a defendant's personal assets.

Other corporate variations, such as S corporations and limited liability companies (LLCs), offer protections similar to those of a C corporation, and those alternative business structures may give you tax advantages. Generally, a C corporation is taxed twice—the business pays income tax, and then you're taxed on the dividend you receive—whereas S corporation shareholders and LLC members get only a single tax bill. The LLC format, compared with the older S corporation, has fewer restrictions, but may have higher taxes in some states.

Owning assets jointly. Another long-standing asset protection strategy is to title property as joint tenants with your spouse or another family member. If assets are owned by "joint tenants with rights of survivorship" (JTWROS), they automatically pass to the survivor upon the other owner's death. A special type of co-ownership only between a husband and wife, known as "tenancy by the entirety" (TBE), may protect assets from creditors. More than half the states now recognize TBE protections.

In the nine community property states, on the other hand, property acquired during a marriage is generally treated as being owned by both spouses, regardless of how it is titled, and could be accessible to creditors of either spouse.

Domestic trusts. Various kinds of trusts created within the United States can help shield assets from creditors. For example, you could establish a "spendthrift trust" for a child. Normally, that involves transferring control of trust assets to a designated trustee, who will manage the trust. Creditors can't touch the assets before the beneficiary actually receives a distribution. The maximum protection is obtained with a discretionary trust which does not require distributions to be made at any particular time.

Self-settled trusts. A self-settled trust is one you form for your own benefit—you're the beneficiary as well as the grantor. Currently, 11 states allow you to establish self-settled trusts to protect assets from future creditors. To qualify, the trust must generally adhere to the laws of the state, have a trustee resident in such state, and be irrevocable.

Foreign trusts. A foreign or "offshore" trust can be a legitimate means for protecting assets by subjecting the property to the more lenient laws of a foreign jurisdiction. But foreign trusts also have disadvantages, including tax reporting requirements, lack of tax benefits, and concerns about trustees.

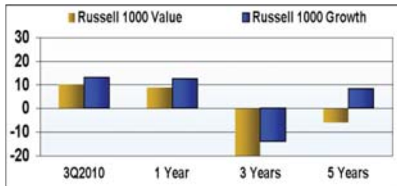
Devising an effective asset-protection plan is often complex and subject to crucial missteps. We can work with you and your attorney to create a plan that provides effective legal protections. ●

extend the minimum term of a GRAT from two years to 10 years, not only making it more difficult to zero out a trust but also increasing the likelihood that you might die during the term. If that happens, trust assets are restored to your taxable estate. The proposed legislation also would require the remainder interest to be greater than zero, ensuring there would always be some gift tax liability.

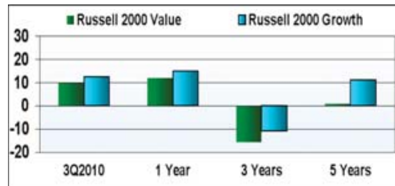
Finally, the bill would prohibit structuring a GRAT with a "declining annuity" during the first 10 years of its term. That structure provides a higher initial payment that that could be used to distribute large gains early in a GRAT's term while guarding against poor performance later.

Although the small business legislation has stalled in Congress, it could be revived in a legislative session after the November election. If you would like to know more about GRATs, please make an appointment now so we can discuss whether it would be a useful estate planning tool in your situation. ●

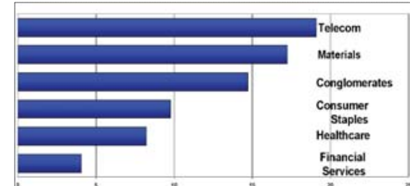
Market Data Bank: 3rd Quarter 2010



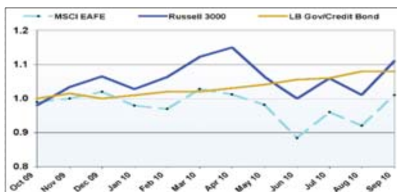
LARGE VALUE VS. LARGE GROWTH
Hope for the U.S. economy's future outweighed recession fears, pushing large- and small-cap shares alike 9% to 13% higher. Growth outperformed, but only by a few percentage points.



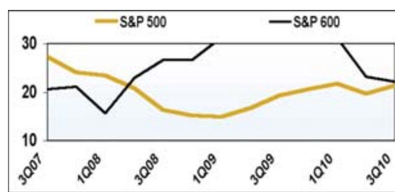
SMALL VALUE VS. SMALL GROWTH
Small-cap indices lagged slightly in 3Q10, but still fared better than their larger counterparts over longer time periods. Small growth has now beaten other strategies over 1-, 3-, and 5-year periods.



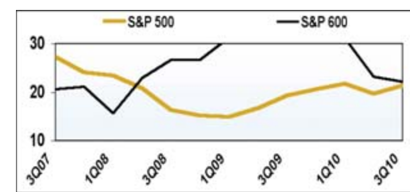
THREE BEST AND WORST SECTORS
All 10 industrial groups that Standard & Poor's tracks were positive. Phone carriers, commodity producers, and manufacturers all saw significant returns, but even banks gained 4% in 3Q10.



FOREIGN, US STOCKS & US BONDS
All in all, U.S. stocks outperformed their foreign peers in 3Q10 and over the 12-month period. Treasury bonds have also stayed ahead of foreign stocks as global investors remain wary of risk.



LARGE VS. SMALL STOCK EARNINGS
Although earnings expansion is no longer "off the scale," small-cap companies managed to boost their bottom lines by 103% in 3Q10, well ahead of their large-cap counterparts' 31% growth.



PRICE-TO-EARNINGS RATIO
Higher stock prices and slower growth translated into richer valuations for large-cap shares. Small-cap shares actually became cheaper on an earnings-per-share basis than at any time since 2008.

Small-cap stocks represented by Russell 2000 index, large-cap stocks represented by Russell 1000 index. Foreign stocks represented by the Morgan Stanley Capita/ International's Europe, Australia, Far East Index, and US bonds by the Lehman Bros. Government/Corporate Bond Index. P/E ratios exclude negative earnings. Small-cap stocks tend to be more volatile than large-caps. Bonds offer a fixed rate of return while stocks will fluctuate. Indices are unmanaged and do nott represent any specific investment. Foreign investing involves special risks, including political unrest, economic instability, and currency fluctuation. Past performance does not indicate future results.

Source: Russell/Mellon

All Or Nothing Proposition

(Continued from page 1)

- The current value of the IRA assets
- The IRA's projected investment return
- Whether you'll need withdrawals and the projected amounts of withdrawals during your lifetime
- The date of the conversion

Suppose a couple—he's 55 and she's 50—has IRA assets totaling $750,000 ($500,000 in his and $250,000 in hers). Assume the account earns a 4% annual rate of return, they are currently in the 33% tax bracket, and they'll take monthly IRA distributions of $1,000. Their only child is age 25.

According to the Roth IRA Conversion Optimizer, a tool used by wealth management professionals to calculate the impact of different conversion scenarios, if the couple transfers the entire $750,000 IRA to a Roth in 2010, they'll realize a $1.42 million net benefit over a consumption period of 29 years—the difference between converting to a Roth and keeping the traditional IRA. This is based on the assumption that they remain in the 33% tax bracket and their child is in the 28% tax bracket in the future. Note: The "net benefit" doesn't reflect the opportunity cost of using the funds that are paying taxes for other investment purposes.

Other variables could affect the outcome, however. For instance, this initial calculation assumes the couple is able to pay the entire tax on the conversion with funds not in the IRA. If they have to dip into IRA assets to foot the tax bill, it will dilute the conversion's benefit. For instance, if they need IRA funds to pay half of the tax, the net benefit of converting all of the assets is reduced to $809,000. In this case, the optimal net benefit of $921,000 would be achieved by converting 60% of the assets.

Remember that other wild cards—rising tax rates, inflation, state and local taxes, and changes in tax laws, for starters—could also influence this calculation. For many people, the optimal solution may be to convert only part of the traditional IRA. You might decide to leave the money you'll need during retirement, and convert the rest to a Roth. We can help you decide what makes the most sense in your financial situation. ●

Vestpointe Wealth Management, LLC
14358 N. Frank Lloyd Wright Blvd., Suite 7 Scottsdale, AZ 85260
Phone: 602-212-1040 • Email: joem@vestpointe.com

©2011 API