

Taxes and the Immediate Future: What to Do Now?

September 2010

As we approach a very contentious election season, one in which the balance of power, and therefore economic policy, appear subject to substantial change and tremendous uncertainty, we wanted to address the issue of taxes very briefly. We feel this is especially important now because the volume of the hyperbole is deafening, and the “search for solutions” appears somewhat frantic.

First of all, let’s address the question concerning what you need to be doing with your portfolio now in light of the coming tax changes. The good news is that there is nothing you need to be doing generally, if you are intelligently tax managing your assets now (as our clients are). Minimizing capital gain realization (especially short-term gains), harvesting losses as the opportunities arise, and keeping the bulk of your interest income tax-exempt will continue to make all the sense in the world.

- *On the other hand, if you are buying T-bills or bank CDs and you are in a high tax bracket, you are making a serious mistake - stop! Municipal bonds, short duration or longer, offer much better after-tax returns with solid credit, despite the “headline risk” related to state budgets. If you are in this position please call us.*

I would add that the uncertainty related to tax policy makes any action taken now a dicey proposition. We just don’t know what is coming. The current administration has been planning to raise taxes on income, capital gains and dividends, reduce exemptions, and make numerous other changes. On the other hand, not only are Republicans and Independents calling for an extension of the current tax rates (due to expire this year), but as we were writing this letter, 31 Democrats in the House sent a letter to the Speaker recommending this wise course. Raising taxes in the face of such high unemployment and anemic recovery would seem ill-advised, and now the tide appears to be turning. One can only hope.

Investment and Tax Management

We carefully consider taxes in all parts of our portfolio strategies, and potential changes in the tax code may well call for some adjustments, once we actually know what those changes will be. We just want to remind you that we are very focused on this and will be communicating with money managers such as Parametric about what the new tax rates and issues might imply for management of equities. For example, if dividends start being taxed at ordinary income rates, will a large cap equity portfolio seek to reduce its dividend yield, holding fewer dividend paying stocks? And how would that affect performance and style (e.g., value/growth balance)? These are complicated questions, and you will be hearing a lot from us on these issues going forward. Naturally if action is advisable we will be recommending changes to you in a timely manner.

**From here
you can see
everything.**

Roth IRA Conversions

One thing you can and should consider is converting some or all of your traditional IRA assets to Roth IRAs. As of this year, the income limitations for such conversions have been removed, and everyone may convert. If you convert you pay the tax now, at today's rates, instead of later (at higher rates?). And if the market goes up a lot in future, you paid the tax on a smaller amount (today's value).

This is actually a very complicated issue; there are many things to consider. Below is a brief outline of the major issues in order to introduce you to the topics, but we *strongly recommend* that you discuss this with your tax advisor before making any decisions. Don't try this at home, folks.

Sincerely,

A handwritten signature in black ink that reads "Roger C. Hewins III". The signature is written in a cursive style with a large, stylized 'R' and 'H'.

Roger C. Hewins III
President

Roth IRA Conversions: A Simple Summary of Critical Issues

Converting IRA assets to Roth IRA assets offers a number of benefits. The conversion requires paying the tax now, at current rates, but allows you to convert the entire amount to a Roth account (paying the tax with outside money), thus effectively owning more of your assets, with no tax liability, in a qualified account. It is never taxable thereafter (based on current law), plus Required Minimum Distributions (RMDs) are not required, meaning the assets can stay in the account for the rest of your life.

Key Disadvantages of the Traditional IRA:

1. Tax “liability” inside the IRA grows with market returns, i.e., part of the IRA balance is owed to the government; it is not really yours.
2. Increases in future tax rates may result in an even higher future tax liability for you.
3. RMDs start at age 70 ½:
 - a. forcing you to pay tax at that time;
 - b. potentially putting you in higher tax bracket each year;
 - c. removing those assets from the tax-sheltered account, making them taxable going forward.
4. Pre-tax balance is taxed at death as part of estate, then taxed again as it is distributed to heirs.

Key Benefits of Roth Conversion:

1. Pay off liability inside the IRA with cash from outside the IRA, meaning all the assets in the IRA are now yours, growing tax-free for you and your heirs. It is like getting to put more money into the tax-free account and keep it there for the rest of your life and much of the lives of your heirs as well.
2. Pay tax now at current rate, which may be lower than your future tax rate.
3. No RMDs to you:
 - a. you can keep the assets in the account for your lifetime;
 - b. if you take money out it creates no tax, will not put you in higher tax bracket and allows for tax planning;
 - c. RMDs to heirs after your death, still tax-free.
4. Reduces estate tax – the tax paid is now out of your estate.

Exceptions – Specific Circumstances When a Conversion is Not Advised

1. Charitable donations – if you intend to donate IRA assets to charity.
2. If you expect to pay taxes at a lower rate in the future.
 - a. You think rates will drop (you are in the minority on that one);
 - b. You will have years with low income (don't forget to include RMDs in income) and therefore will be in lower tax brackets (e.g., after retirement).
3. You don't have the cash (outside the IRA) needed to pay the tax upon conversion.
4. You need the money from the IRA within five years.
5. You (and your spouse) are near death, no estate tax issue, and heirs are and will remain in low tax brackets.
6. Income from conversion puts you in higher than normal tax bracket this year.

Exceptions – General Concerns

1. You just hate paying taxes before you have to.
2. The general uncertainty surrounding many of these issues makes you reluctant to take a step like this and pay taxes now.
3. You are concerned that the government will renege on its pledge to leave your Roth assets tax- free, and will tax the growth after all, directly or indirectly.

Like a Home Mortgage?

Think of it like a home mortgage. The home is the total value of your IRA, and the mortgage is the tax you will owe the government. So you don't really own the entire home; if the home is worth \$500k and the mortgage is \$200k, you own a net of \$300k of equity. Likewise, in a \$500k IRA, your part is only the amount you have left after you pay taxes.

The difference is that your mortgage does not go up with the value of your home! But the tax owed in the IRA goes up in lockstep with the IRA return. If the bill is \$200k today (40% tax rate), and the account doubles from \$500k to \$1m, your tax bill doubles to \$400k. If tax rates rise, it gets worse.

So converting your IRA to a Roth IRA is, in effect, paying off the tax liability now, before it grows.

Nice bonus – you get the option to “recharacterize,” which means that you can change your mind and roll the assets back to the IRA before you file your tax return, and then try again. There are rules, of course. If the market declines sharply after you convert, recharacterizing and then reconverting at a lower market level can reduce the tax bill.

For a simple view of it, let's compare two straightforward scenarios.

- In one, you convert \$100,000 to a Roth and pay \$40,000 or so (depending on your state) in tax from assets outside the IRA.
- In the other you don't convert, and you invest the \$40,000 as taxable assets in a "tax reserve" account, achieving an after tax return lower than the IRA return because you pay taxes along the way.

In the end, assuming accounts are up 100%, when you distribute the IRA money:

1. If you converted to a Roth, there is no tax, you get \$200,000 from the Roth IRA, the new value of \$100,000 after the growth.
2. If you didn't convert, you still get \$200,000 from the IRA, but you owe taxes of \$80,000 (if tax rate is the same)
 - a. "tax reserve" account is less than the \$80,000 of tax you owe; it might be only \$65,000, because all the gain and income earned was taxable. You have to reach into your pocket for more cash (e.g., an extra \$15,000).
 - b. So you only have \$185,000, not \$200,000.
3. If tax rates went up, the difference is even larger. You lose big. If the total state and federal tax is now 55%, you owe \$110,000.
 - a. Since your tax reserve account is worth only \$65,000, you owe an additional \$45,000.
 - b. So now your proceeds are down to \$155,000, instead of \$200,000.

Summary

Point 1: a Roth IRA conversion is a good idea for many people

Point 2: as always in tax issues, there are **many rules**, exceptions, qualifications and technicalities. Don't try this at home--see your tax advisor!

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