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converting a pre-tax account to a Roth IRA: opportunity or peril?

Beginning January 1, 2010, individuals may convert a pre-tax IRA or roll a qualified plan balance to a Roth IRA regardless of their income. As with most tax planning, this decision has a number of considerations.

background

Contributions to a Roth IRA are not tax deductible. However, there is a tax benefit upon distribution. Generally, the Roth account permits a tax free distribution if the following two criteria are met:

- A five year period has elapsed. This period is measured from January 1 of the first year that a contribution or rollover is made and ends on December 31 of the fifth year (e.g., if the first contribution is made March 1, 2010, the five year period would end December 31, 2014).
- The distribution occurs on or after the taxpayer turns age 59½, dies, or is disabled.

Prior to 2010, the Tax Code limited the ability to convert a pre-tax retirement account to a Roth IRA based upon the adjusted gross income (AGI) of the taxpayer. In 2009, individuals with AGI of \$95,000 and married couples with AGI of \$150,000 were not eligible to convert. These income restrictions no longer apply effective January 1, 2010. However, despite the removal of income limits, two questions remain:

question 1: can I roll my 401(k) account?

The new law only permits a Roth conversion of pre-tax assets that are either currently in an IRA or distributed from a qualified plan. It is not possible

to convert to Roth within a qualified retirement plan. The account must be rolled out of the plan to make the conversion.

In order to roll a sum from a 401(k) or profit sharing plan, the plan must permit the withdrawal. Depending on plan provisions, many participants may not meet the distribution criteria. Generally, a plan will permit distributions:

- At termination of employment
- From balances rolled over from a prior employer's plan
- Upon attaining age 59½ (or age specified in document)

If the plan participant does not have a distribution event, then a rollover cannot occur and a Roth conversion is not possible.

question 2: should I roll my account?

The answer to this second question is tied to three considerations: income tax consequences, the required holding period for a Roth account, and the taxpayer's investment goal.

a. tax consequences of rollover

Rolling a pre-tax account to a Roth IRA is not tax free. The rollover triggers ordinary income to the taxpayer at his/her top marginal rate. In the excitement to obtain tax free distributions at retirement, some individuals overlook the fact that all of the income from this rollover must be recognized in the year of rollover. Others misconstrue the portion of the new law that waives the usual 10% excise tax on early distributions from an account. They incorrectly conclude that income tax is waived when in reality the tax code only waives the early distribution penalty.

special tax consequences for 2010 conversions

To complicate matters further, there is a one-time income recognition decision available for 2010 conversions. The tax payer may either

recognize the rollover income in 2010 or have it deferred ratably between 2011 and 2012.

For example, in 2010 Alice and Bob have taxable income of \$200,000. Bob rolls his \$100,000 401(k) account to a Roth IRA. He is not subject to the 10% excise tax on the rollover, but the rollover of \$100,000 is all taxable. The couple may recognize the \$100,000 in 2010 (for a total of \$300,000 of income) or opt for recognizing \$50,000 in 2011 and \$50,000 in 2012. If the couple elects to recognize the income in 2010, the rollover costs them an additional \$32,507 of federal income tax plus any applicable state income tax.

As noted above, the taxpayer has a one time opportunity in 2010 to defer the rollover income, half to 2011 and half to 2012. Although deferring income is usually wise, it is a more complicated decision in light of tax rate increases which may occur in 2011 and 2012. The current 2010 rates are the result of tax legislation passed in 2001. This legislation will automatically expire January 1, 2011, if Congress takes no action. At that point the favorable tax brackets of 2010 go away. The more burdensome rates imposed prior to 2001 reappear in 2011 and beyond.

Continuing the above example, assume Alice and Bob elect to recognize the \$100,000 rollover as income ratably in 2011 and 2012 when the tax rates revert to the higher pre-2001 levels. Rather than being at a marginal rate of 33%, they are now in the 36% bracket. Their election to delay paying the tax will increase their obligation to \$36,000. This is an increase of \$3,593 over the tax burden if they had recognized the entire \$100,000 in 2010.

b. required holding period for Roth IRA

In order for the taxpayer to receive the income as a tax free distribution from the Roth account, the distribution must be "qualified." To be qualified, the account must be held for 5 years and the taxpayer must be at least age 59½, deceased, or disabled at the time of distribution. If the distribution is not qualified, then gains are taxed using an ordering rule. Distributions from the Roth account are taken first from contributions, then from earnings. In light of

these criteria, the taxpayer must decide when he/she will need to take Roth distributions.

Continuing the above example, assume Bob is age 62 when he rolls the \$100,000 in 2010. Bob becomes disabled the following year and begins to take distributions from the account. Once his distributions exceed \$100,000, then they will be taxable if the account has not been in place for the required 5 years.

c. investment goal of the Roth account

If the Roth account meets the criteria for a qualified distribution, then all investment growth is tax free. With this premise, the taxpayer generally would want to invest the Roth account in riskier investments with the hope that they would skyrocket in value before being withdrawn. All gains would be tax free. However, if an individual is risk adverse or is older and does not have the time required to use riskier investments, then the relative advantage of the tax free account becomes diminished.

Continuing the above example, assume Bob wants to invest his \$100,000 rollover in a bank certificate of deposit (CD). Although it may be comforting to know that the interest on his CD will be tax free, he has paid immediate tax in excess of \$30,000 to obtain this benefit; hardly a fair trade off.

conclusion

The ability to convert a pre-tax retirement account to a Roth IRA offers the allure of tax free income at retirement. However, before making the decision to convert to a Roth account, individuals should consider the potential taxation on the transaction, their future withdrawal needs for the account and their investment goals. As with all tax planning opportunities, the decision will rest with the particular circumstances of the taxpayer. He/she should seek the assistance of their accountant or other qualified professional before taking action.

investment update



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stocks rally as governments intervene

In 2007, the housing bubble in the United States and many European countries burst and it appeared that loan losses as a result of the bursting of this bubble would cripple the financial system in the West. Investors fled stocks and other risky assets. By March 2009 the Dow Jones Industrial Average had fallen almost 54% from its high in October 2007. Fears of a second Great Depression were rampant. Many believed that the

nation's largest banks would have to be nationalized.

Governments around the world engaged in an unprecedented and coordinated effort to rescue the global financial system from collapse. Low interest rates, quantitative easing, recapitalization of the banking system, and liquidity support to banks and money markets were a few of the programs that were implemented. The United States and China also promised large fiscal spending programs to help stimulate their economies.

All this government intervention appears to have had the desired effect. The financial system is more stable and global economies have begun to grow. Investors have also obliged and moved back into stocks and other risky assets. The Dow Jones Industrial Average rose 59.3% from its March lows and ended the year up 18.8%. Technology and basic material stocks, leveraged to the global recovery, did the best—up over 62% for 2009, while defensive sectors such as telecommunications and utilities lagged. Shares of Freeport McMoRan Copper & Gold, a copper and gold mining company, surged 228% and shares of Internet retailer Amazon and computer company Apple more than doubled.

International stock markets fared much better than U.S. markets. The Dow Jones World [ex. U.S.] Index rose almost 40% in 2009. The riskiest emerging markets were once again star performers. The MSCI Latin America Index rose 98%, Russia's RTS Index grew 128%, and India's Sensex was up by more than 80%. The Federal Reserve's 0% interest rate policy weakened the dollar relative to foreign currencies enhancing international market returns in dollar terms. Japan's Nikkei was the worst performing market—up only 19% for the year. The Nikkei is now down 79% since its peak in 1999.

bonds: more of the same

In late 2008 and 2009, the Federal Reserve intervened in the credit markets to enable them to function smoothly and to support the housing market. The Fed provided overnight liquidity to banks and commercial paper markets, offered a temporary guarantee program to help banks issue debt, bought agency and mortgage-backed securities to support the crumbling housing market, and purchased Treasuries to help the U.S. government fund its stimulus program. All these actions had a similar effect on the bond market as the stock market. Investors grew more confident that the worst of the credit crisis was behind and moved money from low yielding Treasuries and money market funds into riskier corporate bonds and asset-backed and mortgage-backed securities.

High-yield junk bonds returned 57.5%, with the riskiest triple-C rated securities up over 100%. Yields on junk bonds fell from a record 22% to 8% over comparable Treasuries. Investment grade corporate bonds also did well—returning 20% as their spreads over Treasuries fell from 6.25% to 2%. As rates fell highly rated companies issued over \$1 trillion in debt in 2009. Meanwhile Treasury bonds fell as investors sought higher returns in riskier assets and the U.S. government issued \$2.1trillion of new debt to fund its various programs and budget deficits.

commodities in sweet spot—weaker dollar, emerging market demand economic recovery

Stimulus spending in China and a weak dollar helped commodities rally in 2009. The Dow Jones-UBS Commodity Index rose 19%. Leading the charge was copper, a metal that is key to industrialization of emerging countries, which rose 139%. Lead, platinum, and palladium used by automakers jumped from 50% to 100% as the global economy recovered and excess liquidity ended up speculating on commodity futures. Gold was up 24% as central banks in many countries diversified their dollar reserves and many retail and institutional investors bought it as a hedge against paper currencies.

Energy continued to be a story of divergence. Oil prices rose 78% from \$44.50/barrel to \$79/barrel in 2009. Weaker dollar, global growth, and easy money fueled the price of oil. Natural gas, on the other hand, ended the year at \$5.6 per million BTUs—flat for the year. While oil is priced in global markets, natural gas is priced in local markets. New drilling techniques in the U.S. have produced an abundant supply of natural gas, and natural gas prices are often slower to respond to economic growth.

real estate—the pain continues

Home prices have fallen 30% since their peak in 2006, according to the S&P Case-Shiller index. One in seven homeowners is either in foreclosure or delinquent on their mortgage, and almost one in four homeowners has negative equity in their home. If house prices continue their fall and unemployment stays high, those who owe more on their mortgages than their homes are worth will have an incentive to turn in their keys. This will further increase bank losses and erode capital. Home prices have been helped by an \$8,000 tax credit to first time homebuyers and the Federal Reserve's commitment to purchase \$1.25 trillion of mortgage-backed securities. Both these programs run out in March 2010.

Meanwhile the last leg of the real estate bubble, commercial properties, has burst. Prices on industrial, retail, and office properties are down 20% to 30%. Many developers, property owners, and regional and community banks will go out of business over the next couple of years.

2010 outlook: clouded by moral hazard

The bursting of the real estate bubble in 2007 led to the near collapse of the financial system and the largest decline in economic output since the Great Depression. The Federal Reserve, the Obama administration, and governments around the world have poured trillions of dollars into the global economy in an effort to prevent a second Great Depression and alleviate the pain. These efforts appear to have worked as bank earnings have stabilized and economic growth resumed. However investors are asking questions such as, "What are the unintended consequences of these actions" and "Will the global economies prosper once governments withdraw their support?" Answers to these questions will determine the fate of the U.S. economy and financial markets.

Our views are based on the intentions of the Federal Reserve. The Fed believes that deflation and an unemployment rate that exceeds 10% are unacceptable. The Fed considers the economy to be at full employment when the unemployment rate falls below 5%. It is going to be a few years before we get to full employment. The Fed would also prefer to inflate away our public debt obligations. Thus we expect the Fed to keep interest rates low for an extended period of time. Inflation is within the Fed's comfort zone and is expected to stay low, enabling the Fed's loose monetary policy. Emerging markets are growing at a torrid pace, which should be supportive of U.S. and European exports and the profitability of large multinational companies.

A "best case" scenario is that a self-sustaining recovery is underway and should build momentum as fiscal and monetary stimulus fades in the second half of 2010. This would be good for commodities and other hard assets, global equities, and corporate bonds. The Federal Reserve would gradually increase interest rates boosting the dollar and gold prices would fall. With the U.S. issuing record debt to fund its deficit, government bonds are likely to underperform riskier assets.

Another less desirable scenario could evolve as well. Once fiscal and monetary stimulus is withdrawn, economic growth will slow to 1%-1.5% in the second half of 2010. As a result, unemployment will remain high or increase, delinquencies will rise as homeowners with negative equity and no jobs walk away, and consumer deleveraging will hurt corporate profits. Such a scenario would be positive for government and investment grade corporate bonds, but would hurt equities, commodities, and high-yield corporate bonds. If the U.S. government continues to spend to support the economy, the dollar will fall and gold prices will rise.

Given the wide range of potential outcomes, investors should stay broadly diversified among the different asset classes—government and corporate bonds, equities, commodities, gold, and cash. For long-term investors, we have a couple of specific recommendations. First, with interest rates at historically low levels and housing prices down 30-35% from their peak, this is an excellent time to buy a new home or trade up to a more expensive home. Second, we recommend stocks of multinational U.S. companies such as McDonalds, IBM, Proctor & Gamble, and Johnson and Johnson. These companies have excellent balance sheets, access to credit markets, growth in emerging markets, and reasonable valuations. We expect these companies to outperform most other financial assets over the next five to ten years.

Sources: Wall Street Journal, Bank of America Merrill Lynch, Goldman Sachs

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