

True North

Compass Financial Consulting, LLC

Providing Financial Direction

Fall 2009

“To Roth or Not To Roth—That is the Question”

In a few months, you will have the opportunity to consider converting your traditional IRA to a Roth IRA. Prior to 2010, such a conversion was rarely available to our clients because of a host of restrictions in the tax code. However, beginning next year, Congress has permanently repealed those restrictions. So, given that “next year” is only a few months away, we think it wise to get a head start on the conversation—To Roth or Not To Roth.

Let us start the discussion of what a Roth IRA is and contrast the Roth with a traditional IRA. About 12 years ago, a new retirement plan called the Roth IRA was created. It allowed a taxpayer to open a retirement account using “after-tax” dollars, whereas a traditional IRA, in the majority of cases, is funded with “pre-tax” dollars.

In these investment vehicles, as in most situations these days, you will get taxed. It is just a matter of whether it will be as you open the account or in retirement when you begin to withdraw your money. The “pre-tax” nature of a traditional IRA means that, when you open the account, you will not be taxed. Logic tells us that you will, then, be taxed in retirement. The “after-tax” verbiage used with the Roth IRA means that you are taxed when you open the account, consequently, your retirement withdrawals will be tax-free.

A second major difference between these two types of IRAs has to do with “required” withdrawals from each of them. A traditional IRA requires you to begin taking withdrawals from it once you reach age 70 1/2 .

A Roth IRA has no such required distributions. Instead, you are free to leave all the money you have in it for your entire life, never having to pay attention to a government mandated distribution schedule. You can then pass the Roth account to your heirs who can enjoy the continued benefit of tax free growth and distributions. The compounding effect, free from tax obligations, grows more powerful the longer the Roth can sit unharmed by the tax man.



We are sure that a few of you are now thinking, “With tax free withdrawals and no required distributions during your lifetime, surely the answer to the question from above is, ‘To Roth.’” Well, we caution you not to jump to conclusions too fast for, as Shakespeare would surely agree, any good play contains a subplot.

With a Roth IRA conversion, that subplot involves the taxes you will owe upon moving your money from a traditional IRA over into a Roth IRA. Remember how “pre-tax” dollars are the main ingredient in traditional IRAs? Well, to make them eligible for use in a Roth IRA you need to convert them into

“after-tax” dollars. You do that by reporting the conversion as income on your tax return.

Say, for example, you convert a \$100,000 pre-tax traditional IRA into a \$100,000 Roth IRA. In the calendar year of the conversion, you would report additional income of \$100,000. This amount is fully taxable, and, at today’s rates, would put you into the 25% or higher federal tax bracket. When we consider any applicable state taxes, you could find that upwards of one-third of your conversion is owed as tax (i.e., \$100,000 x (25% federal + 6% state)). (Note: Congress has put forth a little goodie to entice people to convert in 2010 by allowing them to delay reporting the conversion income until 2011 and 2012. This tax deferral goodie is available for a 2010 conversion only).

Effectively, though, you are paying income taxes earlier rather than later with a Roth conversion. This logic is a bit difficult to grasp at first for it runs counter to most tax strategies which try to *delay* the payment of taxes for as long as possible. We think that the idea of having folks pay taxes now, instead of later, was the logic Congress used when removing the Roth conversion restrictions. After all, Congress certainly would prefer the tax revenue now, not later.

The prepayment of income taxes is, by far, the highest hurdle to jump over when answering, “To Roth or Not To Roth.” First, it is essential that you have the money to pay these conversion taxes somewhere outside of your retirement

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accounts. The math of a conversion stops making sense if you are unable to put 100% of the converted amount into the Roth IRA. To make matters worse, if you are under age 59 1/2 and use the converted Roth funds to pay the resulting tax, you will pay an additional 10% early withdrawal penalty. Ouch! If the money to pay the conversion taxes is not available outside of your IRAs, then the best path most likely lies in the “Not To Roth” direction.

Secondly, when analyzing the prepayment of taxes, we need to consider future tax rates. In its simplest form, a Roth IRA conversion works best when you are subject to a tax bracket, today, that is lower than a tax bracket you will face in the future. Given our country’s deficits, it is easy to assume tax brackets will only move higher. Indeed, we already know that marginal tax rates will increase with the sunset of the Bush tax cuts in 2011. However, we must consider that ever increasing marginal brackets, and their punitive effect on IRA distributions, is not the only way our country might decide to raise future tax revenue. Thinking outside of the box, one should consider the ability for Congress to institute such things as: a higher payroll (i.e. FICA) tax, a national sales tax, or a value-added tax.

We mention these “outside the box” options because it is important to consider other ways that taxes might be raised that would not affect the rates you would pay on a traditional IRA distribution. When you are thinking of pre-paying a conversion tax, it is very important that you weigh such alternative tax paths, so that when you write what could be a very big pre-payment check, you do so satisfied that a future environment, possibly “less taxing” to your traditional IRA distributions, will not exist. It will also not hurt if you are genuinely excited about the idea of Congress naming something after you for paying your taxes early, like a national park, federal building or a bridge!

Another concern lurking in most people’s minds is whether the government could change the rules. A legitimate fear is that you make the conversion to a Roth IRA, pay the tax, then, the government, like a

four year old landing on the “lose a turn” square of a board game, shouts, “Ha, Ha, that doesn’t count because my new rule is that the spinner has to spin 3 and a half times before you can move.” (Hmmm, sounds like we have some experience playing board games with four year olds). Anyway, the fear is that, Congress, one day, changes the rules and eliminates the Roth’s tax-free nature. While we tend to think that if they ever considered such a change that they would “grandfather” previous conversions (versus face the wrath of their Roth IRA constituents), it will always be a risk and is a reason why you will want to be very clear that this risk falls far short of the potential financial rewards that a conversion provides you.

Truly, whether a conversion to a Roth IRA makes sense is client specific and should be based on a critical analysis of your individual financial position and goals. However, let us paint you a picture of a couple general scenarios where a conversion may make sense.

Scenario One

You are age 45 or younger and, therefore, will have sufficient time over which the conversion can work for you. A simple illustration can show you the compounding power of a conversion over time:

Assume a 45-year old converts a \$25,000 traditional IRA to a Roth IRA. As a result of the conversion, they would owe about \$7,200 in “prepaid” tax. Assuming some standard portfolio growth rates (i.e., 8% pre-retirement and 6% after retirement), the Roth IRA would approach \$205,000 in value by age 75. Conversely, if the traditional IRA had remained in tact, it would have grown to an after-tax balance of about \$175,000. So, by doing the conversion, our example 45-year old has realized a \$30,000 financial benefit by age 75.

If you continue to forecast a Roth’s tax-free advantage to the heirs who will inherit the account at the death of our original IRA owner, well, you start to see some astounding numbers. What is an example of an astounding number?

In our case above, that \$25,000 traditional IRA could turn into a \$1.6 million Roth IRA by the time of the heir’s death at age 85.

But, again, it would be important that our original 45-year old has the \$7,200 necessary to pay the resulting conversion tax available outside of their converted retirement account, and that our 45-year old is convinced that future tax rates play to a Roth conversion’s advantage.

Scenario Two

You have a significant asset base that presents you the opportunity of never needing to use your IRA assets. In addition, we assume that your IRA assets play no role in your charitable giving plans. Remember, traditional IRAs are one of the best assets to give to a charity as the charity will owe no income taxes as a result of the gift. Using these assumptions, a conversion to a Roth IRA can help lessen the potential estate tax burden, as well as create a valuable tax-free “legacy” asset to leave to your children.

Like we said earlier, the answer to the question of whether “To Roth Or Not To Roth” is best made after an analysis of your specific and individual situation. There are many other tax considerations and scenarios that will need to be analyzed, such as whether the conversion will push you into a significantly higher tax bracket or throw you into the dreaded world of the Alternative Minimum Tax. We look forward to helping you analyze whether a Roth conversion in 2010 will make sense in the scope of your financial plan.





A cure for the “I’m not making any money on cash” blues and other related ailments.

If we were to create a list of topics most discussed with clients over the past year, two topics near the top of the list would be the health of their bank and how to get their emergency cash earning more interest than what “under their mattress” pays. We have had a lot of conversations encouraging clients to be vigilant in monitoring their bank balances so as not to violate the FDIC insurance ceiling (\$250,000 per depositor). We have also been searching for alternatives to obtain higher interest rates without sacrificing safety, an important lesson learned over the past twelve months where even money market accounts lost value and “safe” bonds have caused some sleepless nights.

During some of those conversations, clients challenged us to find a good banking solution for them. Given that we have clients all over the country, such a solution would need to have a national presence, yet it could not be one of those banks labeled as too big to even say “Thank you,” or, perhaps more poignantly, say, “We are sorry,” to the U.S. taxpayer.

Our investigation of a national banking solution actually led us back to a bank we first discovered while researching unique ways to own gold (see the Spring 2009 issue of True North). EverBank® is a Jacksonville, Florida based institution founded in _____ (the blank is on purpose, please see our trivia question on the last page). Since then, it has accumulated \$7 billion in assets and obtained a national presence via its award winning website. Most importantly, EverBank® has become a financially strong and stable institution. In 2008, they had record net income of \$46 million and a loan portfolio that has largely avoided the exotic loans that have put other banks on life support. Their net charge-offs of bad loans was less than 1% for the first half of the year, and the FDIC deems the bank to be “well capitalized”.

Therefore, with our acceptance into the EverBank® advisor program, we are

pleased to be able to offer clients who desire it, a competitive banking solution. This solution includes money market and certificate of deposit rates guaranteed to be in the top 5% of the national rates tracked by Bankrate.com. Even their regular checking account pays a competitive interest rate. As of 10/2/09, their checking account rate was 2.51% for the first three months, followed by a tiered schedule featuring a minimum 1.20% rate.

Featured EverBank® Rates include:

Rates as of 10/2/2009 12:00:00 AM	
Interest Checking Account²	
New Accounts	Bonus Rate
First 3 months	2.51%
Account Balance	First-year APY
\$50,000 - \$99,999	1.72%
\$25,000 - \$49,999	1.31%
\$10,000 - \$24,999	1.23%
\$9,999 or less	1.20%
Money Market Account³	
New Accounts	Bonus Rate
First 3 months	2.51%
Account Balance	First-year APY
\$50,000 or less	1.77%

But this banking solution has more to offer than just checking accounts. For example, we can now enroll clients in the FDIC’s CDAR program through EverBank®. Participation in a CDAR program means one can protect up to a \$50 million deposit in a single banking institution with FDIC insurance. This provides much more coverage than the standard \$250,000 FDIC limit.

Aside from personal accounts, clients have the ability to open both business accounts as well as non-profit accounts, which also offer competitive interest rates. Their advisor program also gives us easy access to their home mortgage solutions. As of 10/2/09, their 30 year fixed rate mortgage was at 4.75%. In addition, a client can utilize their full suite of foreign currency offerings, including a unique set of CDs and money market accounts that can be

denominated in either a single foreign currency or a basket of several foreign currencies. Finally, clients have access to their precious metal purchase and storage solution with commission charges of 1% versus the typical 4% commission.

We have approached our relationship with EverBank® as one that will broaden our ability to offer solutions to clients. Based on our conversations from the past year, we realized that we did not have a good banking solution to offer our clients. But, we want to be clear, this new arrangement is not based on a lack of confidence in TD Ameritrade. It is important to understand that TD Ameritrade and EverBank® are two distinct institutions specializing in two distinct lines of business. TD Ameritrade is a brokerage platform best suited for money involved in active investment strategies, whereas EverBank® is a banking platform best suited for money needed for short-term and day-to-day needs, such as a solvency account, money for tax payments, an automobile fund, etc....

As your personal CFO, we think it is important to be able to offer you solutions for both your long-term investment money and your short-term day-to-day money. We also think it is imperative that our solutions come with no conflicts of interest. As such, you need to know that, customarily, EverBank® offers an advisor compensation for accounts opened at the bank. Compass, however, has amended its agreement with the bank by refusing to accept any of this compensation. This refusal is a commitment to our fee-only structure where our firm is paid by you, and only you, for the services performed on your behalf. We point you in the direction of EverBank® because we think it will provide you, and not us, value.

If you are interested in learning more, please contact us or visit www.everbankadvisor.com.

The \$10 House

Always ones for a creative financial solution, we were impressed by this story we found in Business Week. Seems that a Ft. Lauderdale family purchased their \$2.35 million home in 2005, but now the breadwinner is out of work. So, they decided to raffle off their six bedroom waterfront estate. They plan to pick a winner after 300,000 tickets have been sold at \$10 a piece (for a total of \$3,000,000). Now that is creative!

Oh, Baby!

According to the Center for Nutrition Policy and Promotion, families will spend \$225,000 to \$350,000 to raise a child born in 2008 through age 17. No wonder they call children dependents!

Some Historical Perspective

Here are some interesting statistics from 100 years ago. In 1909:

- *The average life expectancy was 47.
- *Only 14% of homes had a bathtub and only 8% had a phone.
- *There were only 8,000 cars and 144 miles of paved road.
- *90% of doctors had no college education.
- *Only 230 murders were reported in the entire country.
- *20% of adults could not read and write.
- *Las Vegas had a population of 30. So, as was said back in 1909, "*What Happens in Vegas[®], Most Assuredly Stays in Vegas[®]!*"

IN PURSUIT OF THE TRIVIAL

The question for this quarter is: "On what date was EverBank[®] officially established?"

We will take answers through 5pm Eastern Time on October 31st. You must respond to either kraus@financialdirection.com or johnb@financialdirection.com with your answer. If you do not have email, you may call us. We will include all those providing the correct answer in a drawing to determine the winner. Staff from the accounting firm of Bridges & Dunn-Rankin will conduct the drawing and certify the results. In typical bank fashion, the winner will receive a toaster (or you may decide between a \$100 Lowe's gift certificate or a Canon Power Shot digital camera).

Answer for Summer 2009. Last quarter's question was, "The Manitowoc company, a stock holding in some of our portfolios, was founded in 1902. What was its original name?" The correct answer was the Manitowoc Dry Dock Company. Congratulations to Suleman and Grace Sadiq, the winner of the drawing from correct answers.



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