



TROVENA newsletter

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Do Roth IRA Conversion Rule Changes Help You?

Why would you volunteer to pay income tax next year by converting a traditional IRA to a Roth IRA? If you leave things alone, you won't owe any current tax on the assets in your account, regardless of their investment performance. But the promise of a future tax payoff—combined with the prevailing economic conditions—may warrant this unusual approach. And thanks to a recent tax law change, a conversion to a Roth in 2010 will be a possibility for all investors, regardless of income.

With a traditional IRA, contributions may be tax deductible, but the amount you deduct and subsequent earnings will be fully taxed as income when withdrawn during retirement. (The same rules apply to IRAs holding assets rolled over from traditional 401(k)s or other employer-sponsored plans.) And you generally must begin taking those taxable distributions during the year after the year in which you turn age 70½.

In contrast, contributions to a Roth IRA are never deductible, but qualified distributions from a Roth that has been established for at least five years are completely tax free. And because the government won't benefit when you take distributions, it doesn't require you to take them.

Until now, the catch has been that high-income individuals can't contribute to a Roth IRA, and converting a traditional IRA to a Roth hasn't been allowed if your adjusted

gross income exceeds \$100,000. The latter rule changes in 2010, when the income cap for conversions is eliminated. And though a conversion to a Roth requires you to pay income tax on the amount you convert, if you make the conversion in 2010, you're allowed to spread out your tax payment over 2011 and 2012.



Choosing between saving for retirement with a traditional IRA or a Roth is in part a question of whether it's better to pay the IRS sooner or later. Being taxed on current

contributions to a Roth IRA or for a conversion from a traditional IRA takes money out of your pocket now, but you may do better later, either enjoying tax-free distributions or passing along the account to your heirs, whose withdrawals also won't be taxed. But the law permitting anyone to convert to a Roth, coupled with the bear market's depressed asset values, adds interesting twists to this debate. Consider these four reasons it may pay to convert.

1. You'll pay less to convert an IRA whose value has plummeted. Rare is the investor who hasn't seen retirement account values fall by at least 25% during the bear market. As painful as that has been, however, it can be an advantage if you choose to convert to a Roth IRA in 2010. You'll be taxed on the value of the account at the time of the conversion, regardless of what it may have been worth a few years earlier. Suppose the assets in your IRA were worth \$500,000 a year ago,

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Trovena Has Embraced Social Media

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Four Charitable Tax Breaks For Businesses

The federal financial rescue plan enacted in October 2008 included a number of high-profile extensions of temporary tax breaks, such as the tuition deduction for individual taxpayers. But it also reinstated several less-publicized tax incentives for small business owners. Among the latter are three extensions that encourage companies to give particular kinds of charitable gifts and one that applies to all gifts by S corporations. All four provisions are now in effect through the 2009 tax year.

1. Donations of food.

Ordinarily, tax deductions are based on the value of the gift on the date of the contribution. But the 2006 pension law approved an enhanced tax advantage for gifts of surplus food for care of the ill, the needy, or infants. The deduction, which takes into account what the food might have fetched if it had been sold, is equal to the lesser of the donated item's original cost basis plus one-half the appreciation in its value—its retail price, in other words—or two times the basis. This tax break is available to the full range of business entities—C corporations, S corporations, partnerships, and sole

proprietorships.

2. Donations of computers.

For charitable contributions of property by a corporation, the deduction is generally limited to the basis in the property and can't exceed 10% of the company's taxable income. But C corporations that donate computer equipment to elementary or secondary schools may claim an enhanced deduction equal to the basis plus one-half of the ordinary income that would have been realized had the computers been sold. The ceiling for this deduction is twice the basis of the property.

3. Donations of books. Under a special exception to the tax laws, C corporations can claim an enhanced deduction for property they donate to charity for the use of the ill, the needy, or infants. A similar exception applies for property donated to colleges and tax-exempt scientific organizations

for use in research, and earlier legislation had temporarily expanded the enhanced deduction to include gifts of books to public schools. The new law revives this tax break for donations of books. Note, though, that this enhanced deduction is available only to C corporations.

4. Basis adjustments of S corporations.

A pension law enacted in 2006 modified the rules for adjusting the basis of S corporation stock when property is donated to charity. Under the modification, the basis reduction equaled each shareholder's pro rata share of the basis of the donated property. That enabled shareholders to benefit from a deduction for the property's fair market value without being taxed on the property's appreciation in value. Though that tax provision had expired after 2007, the 2008 law revived it and extended it through 2009. ●



Four Steps *Not* To Take Right Now

As the tough economic times push on and stock prices fluctuate, it's hard to know what moves to make as an investor. Though the panic you probably felt during the early months of the bear market may have ebbed, your account balances still aren't fun to look at, and the direction of the market is anything but certain. Was the spring-summer market rally the first leg of a new long-term bull market? Or will unemployment, lackluster corporate profits, and a shift from consumer spending to saving postpone the recovery and keep share prices volatile?

Definitive answers may be a long time in coming. But in the meantime, there's no reason to abandon the fundamental investing principles that have worked for you in the past. Here are four moves *not* to make now.

1. Keep your money idle. It's tempting to sit on the sidelines while the markets sort themselves out. But there are two problems with that approach. The first is that if you're going to reach your retirement goals, you'll need growth in your portfolio, and that means putting your money to work in suitable investments. The second is that if your plan is to sit out until markets improve, you'll

inevitably miss much of what the market provides. The best time to buy is when the market is down, not when you feel comfortable, and trying to time your entry and exit into the market almost never works.

2. Chase the golden goose. Trying to get well in a hurry by jumping on the bandwagon for high-flying stocks or high-yielding bonds is another common investing mistake. The best time to invest in a particular sector or category is before a market run-up, not after. You'll probably be too late to the party if you invest heavily when substantial gains have already been realized, and you may be left holding

What Happens After Economic Crises?

What if U.S. home prices dropped by more than a third, and didn't recover for six years? Or if stocks slid by 56% in a three-year bear market? Consider what would happen if the unemployment rate rose by seven percentage points, or per capita economic output fell more than 9%, and didn't recover for two years.

While parts of that scenario may seem extreme, in fact it's just average for almost a score of banking-led financial crises around the world since World War II. In a recent paper, Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University put the current U.S. downturn in global and historical perspective. They considered 18 postwar financial crises around the world, including what they dub the big five: Spain in 1977, Norway in 1987, Finland and Sweden, both in 1991, and Japan in 1992. Add to that group the U.S. upheaval that began in 2007—which is “now beyond contention...severe by any metric,” they write. They also factored in famous emerging market crises, including Asia in 1997-1998, Colombia in 1998, and Argentina in 2001, and incorporated data from the Great Depression. In all of these cases, banking system meltdowns triggered major recessions. The Reinhart-Rogoff paper maps the fallout in several areas and charts how long it took before conditions improved.

By late 2008, when the paper was written, U.S. real housing prices had fallen by almost 28% from their peak—more than twice the decline during the Great Depression. And though many countries have suffered much worse setbacks, including drops of more than 50% in Finland, Columbia, the Philippines, and Hong Kong, the U.S. retreat has approached the 35.5% average noted by Reinhart and Rogoff, who found that the average recovery time for home prices is almost six years.

The U.S. stock market retreated further since Reinhart and Rogoff compiled their data, and prices dipped close to the 55.9% average loss noted in their paper. Here, too, some equity markets have fared much worse, with stock prices in Iceland collapsing by more than 90% during the current crisis and Thai equities sliding about 85% after 1997. Though the average recovery time has been 3.4 years, several markets have taken more than half a decade to bounce back.

Job losses always come with recessions, but when banking crises lead to downturns, the rise in unemployment rates tend to be particularly jarring. The worst was a more than 20 percentage point increase during the Great Depression, a catastrophic result that no postwar recession has approached. Still, the seven percentage point average spike

in unemployment that Reinhart and Rogoff observed amounts to an enormous drag on any economy, and the 9.5% U.S. rate in June 2009 was already more than five points above the low recorded in March 2007. On average, it has taken nearly five years for employment to rebound to pre-crisis levels.

The bottom-line impact of a recession is the decline in a nation's economic output, and by that measure, banking-led crises have also been unusually severe, according to Reinhart and Rogoff. Emerging economies have suffered most, probably because they depend on external credit sources that may dry up when times get tough. Per capita gross domestic product (GDP) dropped by more than 20% in Argentina after 2001 and by almost 15% in Indonesia after the 1997 financial crisis. Much worse, of course, was the nearly 30% plunge during the U.S. Great Depression. But developed countries have also seen economic output drop sharply in more recent times, and on average, recovery takes almost two years.

And the cost to governments of trying to coax their economies back to life? The average rise in public debt during the three years following banking crises has been 86%, according to Reinhart and Rogoff. “Even recessions sparked by financial crises do eventually end, albeit almost invariably accompanied by massive increases in government debt,” they write.

It's not certain, of course, that the current crisis will follow the pattern of past upheavals, and the authors note that some central banks have been particularly aggressive this time in promoting economic recovery. Still, they write, “one would be wise not to push too far the conceit that we are smarter than our predecessors. A few years back many people would have said that improvements in financial engineering had done much to tame the business cycle and limit the risk of financial contagion.” They hardly needed to add that the limits of that hypothesis have become painfully clear. ●

overvalued investments vulnerable to sharp declines, especially while the markets remain volatile.

3. Rely too much on “safe” investments.

Diversifying your portfolio with reasonable allocations to low-risk, low-return investments such as bonds and money markets is smart, but veering too far in that direction can be just as damaging to your long-term prospects as chasing hot stocks or trying to time the market. “Safe” investments bring their own risks, including a loss of value when interest rates rise and inflation picks up.

4. Stop saving for retirement.

When times are tough, paying bills may have to take precedence over saving.

But your future needs are also crucial, and continuing to contribute to your 401(k) or other retirement plan—even, or especially, if its value has plummeted—is the only way to ensure that you'll reach your long-term goals. These turbulent times too shall pass, and it only makes sense to keep working toward your ultimate objectives. In fact, cost averaging into your 401(k) enhances returns when the market drops—a reward for continuing to save. ●



A SCIN Is A Timely Estate Tax Strategy

If there's a single, central objective of most estate plans, it's to transfer property to younger family members while minimizing estate and gift tax liability. Among the many strategies and structures designed to accomplish that goal, one less well-known vehicle—a self-canceling installment note, or SCIN (pronounced “skin”)—may work particularly well with today's depressed asset values and low interest rates.

With a SCIN, you sell real estate, a business interest, or other assets to one or more younger family members, such as your children, in exchange for an installment note with a term shorter than your expected life span. That aspect is required; to realize tax benefits, the note's term must be shorter than the seller's life expectancy, according to IRS tables. But under the “self-canceling” feature of the note, your heirs' obligation to repay the loan automatically disappears if you die before the end of the term.

A SCIN provides several potential tax benefits. If you die early

and there's an unpaid balance on the loan, that amount won't be considered part of your taxable estate. Yet the property still ends up in the hands of your heirs. And because the transfer is a sale for fair value, not a gift, there's no gift tax.

There's also an advantage in using a SCIN to pass along property that has appreciated in value. Though you may owe capital gains tax on the sale, you can spread out that liability over the note's term. (Note that if the assets' buyers are family members, they must wait at least two years to sell the property in order for the capital gains to be prorated and deferred.) The longer term might help you avoid moving into a higher tax bracket, particularly if the term of the loan extends into your retirement years, when your income may be declining. Meanwhile, if the transferred property continues to appreciate, those gains will be

outside your estate.

Because the self-canceling aspect of a SCIN is a risk to your estate, the note must include either an inflated market value for the assets or an interest rate that's higher than the applicable federal rate, or AFR. That can be a drawback of this estate

planning technique. But interest rates now are exceptionally low, and the value of most assets is well below what they may have been worth in recent years. As a result, the interest rate

required for a SCIN may still be quite reasonable. And with asset values depressed, the principal of the note will be lower, and any rebound in prices will, again, occur outside your estate.

If you are interested in transferring property to your heirs, we can work with you and your attorney to consider whether a SCIN could help. ●



Roth IRA Conversion

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but in 2010, they are worth only \$400,000. At the top current income tax rate of 35%, that saves you \$35,000.

2. You'll avoid a higher tax bill later if rates rise. With individual tax rates at near-record lows and tax revenue falling far short of federal budget commitments, tax rates are likely to go up in the near future. It may be better to take your lumps under current tax law—even if all or part of the conversion is taxed at the top rate of 35%—than to risk losing much more of your investment to the IRS later.

3. Converting to a Roth IRA gives you maximum flexibility on distributions. There's not much give in the rules on withdrawals from

traditional IRAs and 401(k)s. Beginning the year after the year you reach 70½, you'll face minimum annual distributions designed to use up the account during your expected life span—and you'll pay a 50% penalty on any shortfall from the required amount. With a

Roth, you can take as large or small a distribution as you choose each year, and you have the option of leaving the account intact to provide tax-free income to your heirs.

4. A partial conversion to a Roth lets you customize your tax liability

and benefits. A Roth IRA conversion needn't be an all-or-nothing

proposition. You can convert as much or as little as you want each year (although the option of stretching out tax payments applies only to conversions in 2010). Making a partial conversion

lets you limit current payments to the IRS while also providing some tax-free income during retirement.

We can help you decide whether a conversion makes sense in terms of your unique situation and overall financial goals. ●

